Clients&FriendsMemo

Final Credit Risk Retention Requirements for Asset-Backed Securities Transactions

October 30, 2014

I. Introduction

On October 21-22, 2014, the federal regulatory agencies responsible for implementing regulations under The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") finalized rules for risk retention requirements in asset-backed securities (as further defined below, "**ABS**") transactions.[1] The final rules (the "**Final Rules**")[2] contain clarifications and revisions to the reproposed rules (the "**Reproposed Rules**")[3] highlighted in Part II–*Executive Summary of Significant Changes from the Reproposed Rules* below, but in most respects the Final Rules are substantially the same as the Reproposed Rules. Parts III through VII below are a restatement of our prior Clients & Friends Memo[4] updated to reflect the Final Rules.

As required by the Dodd-Frank Act, the Final Rules become effective with respect to residential mortgage-backed securities ("**RMBS**") one year after publication in the Federal Register, and with respect to all other ABS two years after such publication.

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1 The Dodd-Frank Act was signed into law by President Obama on July 21, 2010. On April 29, 2011, the Federal banking agencies (the Office of the Comptroller of Currency, the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve System), the Securities and Exchange Commission ("**SEC**"), the Department of Housing and Urban Development ("**HUD**"), and the Federal Housing Finance Agency (collectively, the "**Agencies**") published a joint notice of proposed rulemaking containing proposed rules (the "**Original Proposal**", available at http://www.sec.gov/rules/proposed/2011/34-64148.pdf) to implement the credit risk retention requirements of Section 941 of the Dodd-Frank Act, codified as Section 15G ("**Section 15G**") of the Securities Exchange Act of 1934 (the "**Exchange Act**").

2 The Final Rules are available at https://www.fdic.gov/news/board/2014/2014-10-21_notice_dis_a_fr.pdf.

3 The Reproposed Rules were released by the Agencies on August 28, 2013 pursuant to a notice of proposed rulemaking after receipt of comments from over 10,500 persons, institutions and groups on the Original Proposal. The Reproposed Rules are available at https://www.sec.gov/rules/proposed/2013/34-70277.pdf).

4 Our prior Clients & Friends Memo, "Reproposed Credit Risk Retention Requirements for Asset-Backed Securities Transactions", dated September 13, 2013, is available at http://www.cadwalader.com/resources/clients-friends-memos/reproposed-credit-risk-retention-requirements-for-asset-backed-securities-transactions.

II. Executive Summary of Significant Changes from the Reproposed Rules

The highlights of the Final Rules, including the most significant changes between the Reproposed Rules and the Final Rules are:

- *Repeal of Cash Flow Restrictions:* The proposed restrictions on payments to a horizontal interest retained by the sponsor (such that the rate of payment on that retained interest would not exceed the rate of principal amortization on the transaction as a whole) have been eliminated in the Final Rules. The elimination of the proposed cash flow restrictions is particularly significant for CLOs and CMBS, since compliance with such restrictions was seen by the market as commercially unfeasible, given that investors in the "equity tranche" of a CLO or the "B-piece" in a CMBS transaction require that interest be paid to them on a current basis.

- *Elimination of Certain Fair Value Calculations:* The Final Rules do not require vertical retentions to be measured using fair value. Horizontal retentions must be valued using a fair value methodology acceptable under U.S. GAAP.

- *Exclusion of non-economic REMIC residual interests.* The definition of ABS interest has been modified to exclude non-economic residual interest issued by a REMIC and uncertificated regular interest in a REMIC held only by another REMIC where both REMICs are part of the same structure and a single REMIC issues ABS interests to investors.

- *Credit Risk May be Held Through Majority-Owned Affiliates.* In addition to the sponsor being permitted to hold credit risk through a majority-owned affiliate,[5] originators, originator-sellers and third party purchasers may also do so.

- *Determination of Retained Value.* The required percentage of eligible vertical, horizontal or combined retained interest must be determined as of the closing date of the securitization transaction. Disclosure requirements relating to fair value measurement of horizontal and combined residual interests will be required a reasonable time prior to the sale of the ABS as described in the Reproposed Rules but the Final Rules permits ranges of fair values to be disclosed if the tranche sizes or rates have not been determined. Actual fair value measurements must be disclosed post-closing.

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[5] "**Majority-owned affiliate**" of a person means an entity (other than the issuing entity) that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, such person. For purposes of this definition, majority control means ownership of more than 50% of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under U.S. GAAP.

- *Revolving Pool Securitizations*. The term "Revolving Pool has been substituted for "Master Trust" to accommodate revolving deals in other than trust form. The Reproposed Rules required a sponsor to retain a seller's interest of not less than 5%. The Final Rules require the sponsor to maintain a seller's interest of not less than 5%. The Final Rules amend the definition of "revolving pool securitization" to exclude the monetization of excess spread. The Final Rules permit Sponsors to satisfy the risk retention requirement by holding a seller's interest that is either *pari passu* or partially or fully subordinate to one or more series of investor interests issued, or by holding a subordinate horizontal interest, and permit Sponsors to use cut-off dates in establishing the outstanding value of the revolving pool.

- *ABCP Conduits.* Under the Final Rules an ABCP conduit sponsor may rely on any of the risk retention options in the Final Rules if it meets the criteria for such option and need not be limited to the ABCP option. The Final Rules clarify the types of assets that can be acquired by an ABCP conduit and extends the maximum maturity of the asset-backed CP to 397 days from the nine-months in the Reproposed Rules. Disclosure requirements have been simplified and can be updated monthly rather than at each ABCP issuance.

- *CLOs*. For the most part, the Final Rules relating to CLOs are largely identical to the Reproposed Rules. The Final Rules continue to apply risk retention requirements to CLOs, irrespective of whether the underlying loans are purchased or transferred from various secondary market sources or otherwise; and the Agencies confirm that they view the manager of an open market CLO[6] (the "**CLO Manager**") as its sponsor. The Final Rules preserve the "lead arranger" option as a means of satisfying the sponsor's risk retention requirements with respect to "Open Market CLOs" (as defined below). The disclosures required to be made by sponsors when this option is used have been slightly expanded and the certifications required to be made by the lead arranger and the CLO Manager[7] have been revised to be more in line with those required of depositors with respect to QRMs and other qualifying asset classes.

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6 Throughout this memo, the lowercase use of "open market CLO" denotes an "arbitrage" or "broadly syndicated CLO" (in which the securitized loan assets are purchased on the secondary market), as distinct from a "balance sheet CLO" (in which the securitized loan assets are purchased as a portfolio from a single institution or its affiliates, including the entities that originated such loan assets), while the title case use of "Open Market CLO" denotes a CLO that purchases and holds "CLO-eligible loan tranches" in conformity with §__9 of the Final Rules (*i.e.*, the "lead arranger" option).

7 Note that §__9 of the Final Rules, which sets forth the risk retention requirements for "Open Market CLOs," defines "CLO manager" as "an entity that manages a CLO, which entity is registered as an investment adviser under the Investment Advisers Act of 1940, as amended (15 U.S.C. 80b-1 et. seq.), or is an affiliate of such a registered investment adviser and itself is managed by such registered investment adviser." References throughout this memo to "CLO Manager," solely in the context of "Open Market CLOs," should be read to include the foregoing definition from §__9 of the Final Rules. See the discussion of "Open Market CLOs and the 'Lead Arranger' Option," below.

- *Tender Option Bonds*. The Final Rules permit tender option bonds ("**TOBs**") with a notice period of up to 397 days (as opposed to 30 days, as in the Reproposed Rules) to qualify for the specialized risk retention options contained in the Final Rules applicable to TOBs. The Final Rules add flexibility for sponsors to meet the risk retention requirements: the sponsor of a qualified tender option bond entity may combine tender option bond risk retention options with each other, as long as the sum of the retained interests equal at least 5% (*e.g.*, the sponsor may hold 3% of the face value of the bonds deposited into the entity and at least 2% of the fair value of all ABS interests issued by the entity).

- *Residential Loans*. The Final Rules exempt certain types of community-focused residential mortgages that are not eligible for QRM status, and also exempts certain closed-end loans secured by a residential dwelling (*e.g.*, home purchase, refinance, home equity loans, second or vacation homes, and mobile homes and trailers used as residences). In addition, the definition of QRM and the exemptions for community-focused residential mortgages and 3-4 unit residential mortgages will be subject to period review by the Agencies.

III. The Final Rules

A. General

Section 15G generally requires the applicable Agencies to jointly prescribe regulations (i) to require a securitizer to retain at least 5% of the credit risk of any asset it, through the issuance of ABS, transfers, sells, or conveys to a third-party, and (ii) to prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain under Section 15G and the rules implemented thereunder.

The Final Rules generally require sponsors to satisfy the 5% risk retention requirements for assets they securitize and provide some alternatives for retention by majority-owned affiliates, originators, originator-sellers, and third parties purchasers as discussed below. The party or parties required to hold retained credit risk are generally prohibited from directly or indirectly hedging or transferring the credit risk required to be retained. However, as described below, the Final Rules permit transfers, under limited circumstances, among the sponsor and qualified third-party purchasers in CMBS transactions after a five year holding period. The Final Rules also restrict hedging or transferring the retained risk, subject to sunset provisions, the terms of which differ for RMBS and all other ABS. The Final Rules also contain some exemptions that eliminate or reduce the required risk retention for certain ABS.

The Final Rules apply to a sponsor of an ABS offering regardless of whether such offering is registered with the SEC under the Securities Act of 1933 (the "**Securities Act**") or is exempt from registration.

Under the Final Rules, sponsors (and originators, B-piece buyers and their respective majority-owned affiliates) are prohibited from pledging any retained interest as collateral for any non-recourse financing.[8]

IV. Party to Retain Risk

A. Sponsor

Under the Final Rules, the "sponsor"[9] of a "securitization transaction"[10] in which "asset-backed securities" ("**ABS**")[11] are issued is required to retain an economic interest in the

[8] Although this restriction does not appear to expressly sunset, as is the case for transfer and hedging restrictions discussed in Part V.H, the restriction on non-recourse financing applies to ABS interests "required" to be retained. This suggests that if the ABS interest can be transferred, it should be able to be financed with nonrecourse financing.

[9] "**Sponsor**" means a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity. Note that the definition of "sponsor" under the Final Rules is different than as used in the Volcker Rule. The Volcker Rule's definition of "sponsor" focuses on the degree of control over the issuing entity. As a result, a banking entity might be considered to "sponsor" a vehicle for the purposes of the Final Rules, but not for Volcker Rule purposes, and *vice versa*. Care will be required when drafting documents because the term "sponsor" may be used in different regulatory contexts in the same document.

The Final Rules state that in the context of CLOs, the CLO Manager "typically organizes and initiates the transaction" (by having control over the formation of the CLO collateral pool) and the CLO Manager "indirectly transfers the underlying assets to the CLO issuing entity typically by selecting the assets and directing the CLO issuing entity to purchase and sell those assets". The regulators expressed concern that exempting CLOs and CLO Managers could allow market participants to avoid the requirements of Section 15G by employing third party agents to select assets to be purchased and securitized. CLO Managers would thus be required to satisfy the applicable risk retention requirements in connection with each CLO transaction they manage unless (x) the transaction is an open-market CLO whose assets and structure permit credit risk retention to be held by the lead arrangers of the loan tranches held by the CLO, as described in Part V.F of this memo, or (y) each loan held by the CLO qualifies for the exemption for "qualifying commercial loans" described in Part VI.B.1 of this memo. As a practical matter, CLO Managers may find it very difficult to structure a CLO transaction that satisfies the commercial loan exemption requirements.

[10] "**Securitization transaction**" means a transaction involving the offer and sale of asset-backed securities by an issuing entity.

[11] "**Asset-Backed Security**" has the same meaning as in Section 3(a)(79) of the Exchange Act, which (a) means a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including: (i) a collateralized mortgage obligation; (ii) a collateralized debt obligation; (iii) a collateralized bond obligation; (iv) a collateralized debt obligation of asset-backed securities; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the SEC, by rule, determines to be an asset-backed security for the purposes of the Exchange Act; and (b) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company. In the notice of the proposed rulemaking for the Original Proposal, which used the same definition of Asset-Backed Security, the Agencies

credit risk of the "securitized assets",[12] unless otherwise exempted under the Final Rules. If there is more than one sponsor of a securitization transaction, each sponsor is required to ensure that at least one of the sponsors (or at least one of their majority-owned or wholly-owned affiliates) retains an economic interest in the credit risk of the securitized assets which satisfies the Final Rules.[13]

> *Note: Status as the "sponsor" has significant Volcker Rule implications. The Volcker Rule per se deems the "securitizer" under the Final Rules (which includes any "Sponsor") to be the equivalent of the "organizer and offeror" of the issuer. This means that, if the issuer is a "covered fund" (for example, a fund under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 that fails to qualify for the Volcker Rule's securitization-of-loans exemption), then the amount of ownership interest in the issuer that may be held by the sponsor (and its affiliates) will be capped by the Volcker Rule at 3% or such greater amount as required by the Final Rules. In addition, status as the "sponsor" of the issuer that is a covered fund would restrict the ability of the sponsor or its affiliates to enter into certain transactions with the issuer (such as a loan to, swap with, guarantee on behalf of, or purchase of assets from, the issuer).*

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made clear that "synthetic" securitizations are not within the scope of Section 15G set forth in the Reproposed Rules because the term asset-backed security includes only those securities that are collateralized by self-liquidating financial assets.

12 "**Securitized Asset**" means an asset that: (1) is transferred, sold, or conveyed to an issuing entity; and (2) collateralizes the ABS interests issued by the issuing entity. Under the Reproposed Rules, "**ABS interest**" (1) includes any type of interest or obligation issued by an issuing entity, whether or not in certificate form, including a security, obligation, beneficial interest or residual interest (other than (i) a non-economic residual interest issued by a REMIC or (ii) an uncertificated regular interest in a REMIC that is held by another REMIC, where both REMICs are part of the same structure and a single REMIC in that structure issues ABS interests to investors), payments on which are primarily dependent on the cash flows of the collateral owned or held by the issuing entity; and (2) does not include common or preferred stock, limited liability interests, partnership interests, trust certificates, or similar interests that: (i) are issued primarily to evidence ownership of the issuing entity; and (ii) the payments, if any, on which are not primarily dependent on the cash flows of the collateral held by the issuing entity.

13 Although the Final Rules and the Preamble (as defined below) make it clear that there can be only one party that is acting as the "retaining sponsor" for purposes of the risk retention rules, nothing in the Final Rules or the Preamble seems to prevent a second sponsor that is also an "originator" from taking a portion of the required risk retention in its capacity as an originator.

B. Originator

The Final Rules permit a sponsor to allocate its risk retention obligations to originator(s)[14] of the securitized assets (or a majority-owned affiliate of the originator) in certain circumstances and subject to certain conditions.

For purposes of the Final Rules, an "originator" is the original creditor of a loan or receivable (*i.e.*, the entity that "created" such loan or receivable), and not a subsequent purchaser or transferee. A sponsor that satisfies its risk retention requirement by holding either an eligible vertical interest or an eligible horizontal residual interest (including funding an eligible horizontal cash reserve account) would be allowed to allocate a portion of its risk retention obligation to any originator of underlying assets in the securitization transaction that contributes at least 20% of the underlying assets to the pool by selling a portion of the retained interest to the originator for cash or a reduction in the price paid by the sponsor to the originator for the securitized assets.

The amount of risk retention that an originator may assume must be at least 20% but cannot exceed the percentage, by unpaid principal balance, of securitized assets it originated. The risk retention that an originator may assume must also be held in the same manner and proportion (as between horizontal and vertical interests) as the sponsor.

The originator would be subject to all of the same requirements for holding the risk retention amount and would be subject to the same restrictions on transfer, hedging and financing imposed on the sponsor as summarized in Part V.H of this memo. Although a sponsor may transfer a portion of the retained risk to an originator, the sponsor is obligated to monitor compliance by the originator with the requirements of the Final Rules and to notify the holders of ABS interests of any instances of noncompliance by the originator. The sponsor is also required to disclose to investors, a reasonable period of time prior to sale of the ABS and, upon request, to the SEC and its applicable Federal banking regulators, certain information about the originator and the form, amount and nature of payment for, the interest retained by the originator.

> *Note: Although the percentage of the risk retention requirement that can be allocated to an originator cannot exceed the percentage of securitized assets originated by such originator, the risk retention by such originator is with respect to the entire pool of securitized assets, not just the assets originated by such originator.*

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[14] "**Originator**" means a person who: (1) through an extension of credit or otherwise, creates an asset that collateralizes an asset-backed security; and (2) sells the asset directly or indirectly to a securitizer or issuing entity.

C. Other Parties

As discussed below, the sponsor could satisfy its risk retention obligations if risk is retained by B-piece buyers or originators in CMBS transactions, originator-sellers in certain asset-backed commercial paper conduits or lead arrangers of CLO-eligible tranches in certain Open Market CLOs (or their majority-owned affiliates).

V. Form and Amount of Risk Retention

Unless one of the exemptions described in Parts VI or VII of this memo applies to reduce or eliminate the risk retention requirement, generally, the sponsor of a securitization transaction (or a majority-owned affiliate of the sponsor) is required to retain an economic interest in the credit risk of the securitized assets equal to at least 5% of all ABS interests in the issuing entity issued as part of the transaction, including those retained by the sponsor (other than certain non-economic residual interests)[15].

A. Standard Risk Retention

A sponsor may satisfy its risk retention requirements by retaining an "eligible vertical interest" or an "eligible horizontal residual interest" or any combination thereof that satisfies the risk retention requirements described below, determined as of the closing date of the securitization transaction.

- *Vertical Risk Retention*. An eligible vertical interest is an interest in each class of ABS interests issued in the securitization that constitutes the same proportion of the face value of such class. Therefore, to satisfy its risk retention obligation solely through the use of an eligible vertical interest, a sponsor is required to retain not less than 5% of the face value of each ABS interest issued by the issuing entity. As an alternative to holding multiple interests in the issuing entity, which may increase the sponsor's administrative burden, the Final Rules specify that a "single vertical security," entitling the sponsor to specified percentages of the principal and interest paid on each class of ABS interests in the issuing entity will also meet the definition of eligible vertical interest.
- *Horizontal Risk Retention*. An eligible horizontal residual interest is an ABS interest in the issuing entity that has the most subordinated claim to payments of both principal and interest by the issuing entity and, with respect to which, on any payment date or allocation date on which the issuing entity has insufficient funds to satisfy its obligation

[15] The Final Rules modified the definition of ABS interest to exclude non-economic residual interest issued by a REMIC and uncertificated regular interest in a REMIC held only by another REMIC where both REMICs are part of the same structure and a single REMIC issues ABS interests to investors.

to pay all contractual interest or principal due, any resulting shortfall will reduce amounts payable to the eligible horizontal residual interest prior to any reduction in the amounts payable to any other ABS interest, whether through loss allocation, operation of the priority of payments, or any other governing contractual provision (until the amount of such ABS interest is reduced to zero). The Final Rules permit multiple classes to constitute an eligible horizontal residual interest, as long as they are the most subordinate classes in the capital stack (excluding any non-economic residual interests). To satisfy its risk retention obligation solely through the use of an eligible horizontal interest, a sponsor is required to retain an eligible horizontal residual interest having a fair value not less than 5% of the fair value of all ABS interests issued by the issuing entity, determined in accordance with U.S. GAAP.

- *Combined Eligible Vertical and Horizontal Retained Interest*. If a sponsor retains both an eligible vertical interest and an eligible horizontal residual interest, the percentage of the fair value of the eligible horizontal interest and the percentage of the eligible vertical interest must equal at least 5%.
- *Horizontal Cash Reserve Account*. In lieu of holding all or any part of an eligible horizontal residual interest, the Final Rules allow a sponsor to fund a horizontal cash reserve account to be held with the securitization trustee in an amount equal to the fair value of the eligible horizontal residual interest or portion thereof. The account would be required to be structured to absorb the same first loss risks as would be absorbed by retained horizontal residual securities. To that end, cash in the reserve account must be released to satisfy payments on ABS interests in the issuing entity on any payment date on which the issuing entity has insufficient funds from any source to satisfy an amount due on any ABS interest.[16] Until all ABS interests are paid in full or the issuing entity is dissolved, amounts in the account (other than interest payments received in the account in respect of permitted investments specified in the Final Rules) may not be released to the sponsor.

[16] The Final Rules also permit such funds to be applied to pay critical expenses of the issuing entity unrelated to credit risk on any payment date on which the issuing entity has insufficient funds from any source to pay such expenses, which expenses will be paid prior to any payments to holders of ABS interests (and are made only to parties not affiliated with the sponsor).

- *Required Disclosures*: The Final Rules require that the sponsor cause to be provided to potential investors a reasonable time prior to the sale of the related ABS and, upon request, to the SEC or appropriate Federal banking agency (if any) written disclosures under the caption "Credit Risk Retention" as follows:
  - *Horizontal interest*. With respect to any eligible horizontal residual interest held, a sponsor must disclose, a reasonable period of time prior to the sale of an asset-backed security issued in the same offering of ABS interests:
    - The fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction (or foreign currency amount, if the ABS interests are not denominated in U.S. dollars)) of the eligible horizontal residual interest that the sponsor expects to retain at the closing of the securitization transaction;[17]
    - A description of the material terms of the eligible horizontal residual interest to be retained by the sponsor;
    - A description of the valuation methodology used to calculate the fair values or range of fair values of all classes of ABS interests, including any portion of the eligible horizontal residual interest retained by the sponsor;
    - All key inputs and assumptions or a comprehensive description of such key inputs and assumptions that were used in measuring the estimated total fair value or range of fair values of all classes of ABS interests, including the eligible horizontal residual interest to be retained by the sponsor;
    - To the extent applicable to the valuation methodology used, this would include, but not be limited to, quantitative information about each of the following: discount rates, loss given default (recovery), prepayment rates, default rates, lag time between default and recovery and the basis of forward interest rates used;

[17] The Final Rules state that if the specific prices, sizes, or rates of interest of each tranche of the securitization are not available, the sponsor must disclose a range of fair values (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS interests are issued, as applicable)) of the eligible horizontal residual interest that the sponsor expects to retain at the close of the securitization transaction based on a range of bona fide estimates or specified prices, sizes, or rates of interest of each tranche of the securitization. A sponsor disclosing a range of fair values based on a range of bona fide estimates or specified prices, sizes or rates of interest of each tranche of the securitization must also disclose the method by which it determined any range of prices, tranche sizes, or rates of interest. These changes in the Final Rules resolve a potential circularity problem presented in the Reproposed Rules, which arose because the Reproposed Rules presumed that the value of the ABS interests had been determined, when in fact the calculations were required to be performed prior to pricing.

- The required disclosures must include, at a minimum, descriptions of all inputs and assumptions that either could have a material impact on the fair value calculation or would be material to a prospective investor's ability to evaluate the sponsor's fair value calculations; and[18]
- A summary description of the reference data set or other historical information used to develop the key inputs and assumptions used to measure fair value of all classes of ABS interests, including loss given default and default rates.

A reasonable time after the closing of the securitization transaction, the sponsor is required to disclose:

- The fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS are issued, as applicable)) of the eligible horizontal residual interest the sponsor retained at the closing of the securitization transaction, based on actual sale prices and finalized tranche sizes;
- The fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS are issued, as applicable)) of the eligible horizontal residual interest that the sponsor is required to retain under this section; and
- To the extent the valuation methodology or any of the key inputs and assumptions that were used in calculating the fair value or range of fair values disclosed prior to sale and required under the Final Rules materially differs from the methodology or key inputs and assumptions used to calculate the fair value at the time of closing, descriptions of those material differences.

Note: The Final Rules do not specify what constitute a "reasonable time".

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[18] To the extent the disclosure required includes a description of a curve or curves, the description is required to include a description of the methodology that was used to derive each curve and a description of any aspects or features of each curve that could materially impact the fair value calculation or the ability of a prospective investor to evaluate the sponsor's fair value calculation. To the extent a sponsor uses information about the securitized assets in its calculation of fair value, such information shall not be as of a date more than 60 days prior to the date of first use with investors; provided that for a subsequent issuance of ABS interests by the same issuing entity with the same sponsor for which the securitization transaction distributes amounts to investors on a quarterly or less frequent basis, such information shall not be as of a date more than 135 days prior to the date of first use with investors; provided further, that the balance or value (in accordance with the transaction documents) of the securitized assets may be increased or decreased to reflect anticipated additions or removals of assets the sponsor makes or expects to make between the cut-off date and the closing date of the securitization

If the sponsor retains risk through the funding of an eligible horizontal cash reserve account, the sponsor must disclose:

- The amount to be placed (or that is placed) by the sponsor in the eligible horizontal cash reserve account at closing, and the fair value (expressed both as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and as an absolute dollar amount (or foreign currency amount, if the ABS interests are not denominated in U.S. dollars)) of the eligible horizontal residual interest that the sponsor is required to fund through the eligible horizontal cash reserve account in order for such account, together with other retained interests, to satisfy the sponsor's risk retention requirement;
- A description of the material terms of the eligible horizontal cash reserve account; and
- The same information required in connection with holding an eligible horizontal residual interest regarding methodology, inputs and assumptions used to determine the fair value of all ABS interests and the data and historical information used to develop key inputs and assumptions.

- *Vertical interest*. With respect to any eligible vertical interest, the sponsor must disclose a reasonable period of time prior to the sale of an asset-backed security issued in the same offering of ABS interests:
  - the form of the eligible vertical interest;
  - the percentage that the sponsor is required to retain as a vertical interest; and
  - a description of the material terms of the vertical interest and the amount that the sponsor expects to retain at the closing of the securitization transaction.

  A reasonable time after the closing of the securitization transaction, the sponsor is required to disclose the amount of the vertical interest the sponsor retained at closing, if that amount is materially different from the amount previously disclosed.

B. CMBS B-Piece Buyer Retention

For CMBS transactions,[19] the Final Rules allow a sponsor to satisfy all or a portion of its risk retention obligation if a third-party purchaser ("**B-piece buyer**"), or a majority owned

[19] For a discussion of the Final Rules as they relate to CMBS transactions, see our prior Clients & Friends Memo "Risk Retention for Commercial Mortgage-Backed Securities: Fact Sheet," dated October 29, 2014, available at http://www.cadwalader.com/resources/clients-friends-memos/risk-retention-for-commercial-mortgage-backed-securitiesfact-sheet.

affiliate thereof, purchases and holds (for its own account) an eligible horizontal residual interest in the same form, amount and manner as would be held by a sponsor under the horizontal risk retention option. The Final Rules permit the use of the B-piece buyer retention option for either the entire risk retention obligation or for a portion of the risk retention obligation in combination with a vertical interest held by the sponsor.

The eligible horizontal residual interests can be acquired by up to two B-piece buyers as long as each interest is *pari passu* with the other interest.[20] Each B-piece buyer would be required to satisfy, and would be subject to, all of the requirements set forth in the Final Rules that would otherwise apply to a sponsor that was retaining an eligible horizontal residual interest, including the prohibitions on hedging and transferring any portion of the risk required to be so retained, except as set forth below.

- *Definition of Commercial Real Estate Loan*. Use of the B-piece buyer alternative is only available for ABS transactions that are collateralized solely by commercial real estate loans and related servicing assets.[21] The Final Rules define "commercial real estate loans" as loans that are secured by (1) five or more single family units or by nonfarm nonresidential real property if 50% or more of the source of repayment is expected to be the proceeds of the sale, refinancing or financing of the property or rental income[22] from the property or (2) loans secured by a fee interest in improved land that is leased to a third party if the improvements on such land are nonresidential or residential with five or more single family units.. Excluded from the definition of a "commercial real estate loan" are (i) a land development and construction loan (including one-to-four family residential or commercial construction loans), (ii) any other land loan and (iii) an unsecured loan to a developer.

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20 In a situation where the risk retention is being held by both a B-piece buyer (in a horizontal interest) and the sponsor (as a vertical interest), even thought the sponsor is required to hold a vertical interest in all the CMBS classes issued, including the most subordinate CMBS interests, the sponsor's vertical interest should not be counted as a B-piece interest and should not prevent two independent third-party B-piece buyers from participating in the retention of the horizontal risk retention interest.

21 "**Servicing assets**" are rights or other assets designed to assure the servicing or the timely distribution of proceeds to ABS interest holders and rights or other assets that are related or incidental to purchasing or otherwise acquiring and holding the issuing entity's securitized assets. Servicing assets include amounts received by the issuing entity as proceeds of securitized assets, including proceeds of rights or other assets, whether as remittances by obligors or as other recoveries.

22 "**Rental income**" means (1) income derived from a lease or other occupancy agreement between the borrower or an operating affiliate of the borrower and a party which is not an affiliate of the borrower for the use of real property or improvements serving as collateral for the applicable loan, and (2) other income derived from hotel, motel, dormitory, nursing home, assisted living, mini-storage warehouse or similar properties that are used primarily by parties that are not affiliates or employees of the borrower or its affiliates."

Note: As opposed to the Reproposed Rules, the Final Rules provide that a "commercial real estate" loan includes a loan made to the owner of a fee interest in land that is ground leased to a third party who owns the improvements on the property.

- *General Requirements*. Satisfaction of all or a portion of the risk retention requirement for CMBS transactions by use of the B-piece buyer retention alternative is subject to satisfaction of the following conditions (among others):
  - The CMBS are collateralized solely by commercial real estate loans, as defined above, and related servicing assets.
  - Each B-piece buyer must pay for the eligible horizontal residual interest in cash at the securitization closing.
  - A B-piece buyer may not obtain direct or indirect financing for the purchase of such interest from any other party (or an affiliate) to the securitization (other than a person that is a party solely by virtue of being an investor).
  - Each B-piece buyer must conduct an independent review of the credit risk of each asset in the pool prior to the sale of the CMBS, which review must include, at a minimum, a review of the underwriting standards, collateral and expected cash flows of each loan in the pool.
  - No B-piece buyer may be affiliated with any party to the securitization transaction (including, but not limited to the sponsor, depositor or servicer) other than (i) an investor, (ii) the special servicer or (iii) one or more originators that in the aggregate originated less than 10% of the unpaid principal balance of the asset pool.
  - The securitization provides for the appointment of an operating advisor that is not affiliated with any of the other securitization parties and has no financial interest in the transaction (other than fees for its role as operating advisor), with the following rights and responsibilities:
    - the operating advisor is required to act in the best interest of, and for the benefit of, investors as a collective whole;
    - transaction documents must provide standards with respect to the operating advisor's experience, expertise and financial strength (although the Final Rules do not set forth any such standards, leaving the transaction parties to determine what standards should apply);

- when the horizontal residual interest is reduced to 25% or less of its initial principal balance (whether by principal prepayments, realized losses or appraisal reduction amounts), the special servicer must be required to consult with the operating advisor in connection with, and prior to, making any material decisions relating to the servicing of the mortgage loans, including, without limitation, any material modification or waiver of the terms of a loan agreement, foreclosure or acquisition of a mortgaged property;
- the operating advisor must have adequate and timely access to information and reports necessary to fulfill its duties;
- the operating advisor must be responsible for reviewing the actions of the special servicer, reviewing the reports of the special servicer, reviewing for accuracy and consistency the calculations made by the special servicer and issuing a report to investors periodically on whether the special servicer is operating in compliance with the standards provided for in the transaction documents (including any standards with which that believes the special servicer failed to comply); and
- the operating advisor must have the authority to recommend replacement of the special servicer if the operating advisor determines that (i) the special servicer has failed to comply with the standards provided in the transaction documents and (ii) such replacement would be in the best interest of the investors as a collective whole. If the operating advisor makes such a recommendation, then the special servicer may be replaced upon the affirmative vote of a majority of all CMBS holders voting on the matter. The required quorum for such vote (i) may not exceed 20% of the outstanding principal balance of the CMBS and (ii) must require at least three investors that are not affiliated with each other.

  Note: There is no requirement for an operating advisor if a sponsor retains a horizontal residual interest even if the interests held by the sponsor grant it control over special servicing activities.

- *Disclosure*. The Final Rules require the sponsor to disclose the name and form of organization of each initial B-piece buyer, a description of each initial B-piece buyer's experience in investing in CMBS, and any other information regarding each B-piece buyer that is material to investors in light of the circumstances of the transaction. Additionally, the sponsor must disclose the percentage of the fair value of CMBS that is represented by the eligible horizontal residual interest that each B-piece buyer will retain, the purchase price paid by each B-piece buyer and a description of the material terms of the interest retained by each B-piece buyer.

  Note: The Final Rules require the disclosure of the purchase price of each B-piece. Issuers, underwriters and investors generally consider that information as proprietary and confidential.

- *Exception to Transfer Restriction*. In general, each B-piece buyer must comply with the same restrictions on hedging, transfer and financing as are applicable to a sponsor that retains an eligible horizontal residual interest.[23] However, on or after the date that is five years after the closing date of a CMBS transaction, the B-piece buyer (and any subsequent B-piece buyer thereafter) can transfer a retained interest to another B-piece buyer who will in turn be subject to similar restrictions as the initial B-piece buyer (*i.e.,* no more than two B-piece buyers, must purchase the interest for cash, may not obtain direct or indirect financing from any party to the securitization (or any affiliate), may not be affiliated with any of the deal parties (other than special servicer and less than 10% originator) and restrictions on hedging, transfer and financing).
  - Restrictions on the transfer of a B piece will not apply if all of the mortgage loans in a pool, have been defeased with cash or cash equivalents (which can include obligations backed by the full faith and credit of the United States).[24]

- *Responsibility for Compliance*. Although a sponsor can satisfy all or a portion of its risk retention obligations through the B-piece buyer retention alternative, the sponsor remains responsible for compliance by each B-piece buyer and each subsequent B-piece buyer with the risk retention rules. As such, the Final Rules require the sponsor to maintain and adhere to policies and procedures to monitor each B-piece buyer's compliance. If the sponsor determines that a B-piece buyer no longer complies with the retention requirement it must notify investors in the related CMBS.

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[23] For more detail on these restrictions and the narrow exceptions thereto, see Part V.H.

[24] This provision appears in the context of the B-piece buyer's transfer restrictions (Section __.7(b)(8)(i)) and arguably does not apply to other risk retention parties. We are unaware of any reason to justify this distinction.

C. Revolving Pool Securitizations (Seller's Interest)

Revolving master trusts and similar revolving pools of assets are often used for securitizations when the underlying assets consist of revolving lines of credit (e.g., credit card accounts) or to create ABS having longer maturities than the short-term assets securitized by using the proceeds of maturing assets to acquire new assets during an initial non-amortization period. These pools issue multiple series of ABS interests that are backed by a single pool of assets that are expected to change in composition over time. The sponsors of these trusts typically hold a direct interest in the assets backing the ABS interests. Prior to the occurrence of an early amortization event, the sponsor's interest in the assets backing the ABS interests is typically pari passu with the interests of the holders of the ABS interests.

The Final Rules would allow a sponsor of a revolving asset pool securitization to satisfy the risk retention requirement by maintaining a "seller's interest" in an amount not less than 5% of the aggregate unpaid principal balance of all outstanding investor ABS interests issued by the issuing entity.[25] The seller's interest may be retained by one or more wholly-owned affiliates of the sponsor, including one or more depositors of the revolving pool securitization.

The Final Rules define a "revolving pool securitization" as an issuing entity that is established to issue on multiple issuance dates more than one series, class, subclass, or tranche of ABS that are collateralized by a common pool of securitized assets that will change in composition over time, and that does not monetize excess interest and fees from its securitized assets. This definition is intended to be consistent with market practices and is intended to include revolving trusts that securitize short-term loans, such as insurance premium finance loans, and use the proceeds of maturing loans in order to acquire new loans to collateralize longer-term securities.

Note: The definition of "revolving pool securitization" has been expanded from "revolving master trust" in the proposed rule in order to include revolving securitization structures that are

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[25] A sponsor of a revolving pool may also use either of two forms of subordinated horizontal interest in order to reduce the amount it is required to maintain as seller's interest in satisfaction of the risk retention rule. A sponsor may hold an eligible horizontal residual interest(as described in Part V.A of this memo) in the securitization's outstanding series of ABS interests, or alternatively, may also retain a horizontal interest whose claim to any part of the series' share of the interest and fee cash flows for any interest payment period is subordinated to all accrued and payable interest due on the payment date to more senior ABS interests in the series for that period, and is reduced by the series' share of losses, including defaults on principal of the securitized assets collateralizing the revolving pool securitization (whether incurred in that period or carried over from prior periods) to the extent that such payments would have been included in amounts payable to more senior interests in the series.

commonly referred to as "master trusts" but do not use issuing entities organized in the form of a trust.

Note: The securitization structure need not specifically state its intention to issue multiple series in its organizational documents, as long as the entity has the ability, under its constituent legal powers, to issue more than one series.

The Final Rules define a "seller's interest" as an ABS interest or ABS interests (i) collateralized by the securitized assets and servicing assets owned or held by the issuing entity, other than certain assets not considered a part of seller's interest; (ii) that is either pari passu with each series of investor ABS interests issued, or partially or fully subordinated to one or more series in identical or varying amounts, with respect to the allocation of all distributions and losses with respect to the securitized assets prior to early amortization of the revolving securitization (as specified in the securitization transaction documents); and (iii) that adjust for fluctuations in the outstanding principal balance of the securitized assets in the pool.

Note: Both the definition of "revolving pool securitization" and "seller's interest" are intended to be consistent with market practices. The definition of "seller's interest" is also designed to make sure that the interest retained by the sponsor would be aligned with the interests of investors at a series, rather than a pool, level.

Note: Assets not considered part of the seller's interest are (i) servicing assets that have been allocated as collateral only for a specific series in connection with administering the revolving pool securitization, such as a principal accumulation or interest reserve account; and (ii) assets that are not eligible under the terms of the securitization transaction to be included when determining whether the revolving pool securitization holds aggregate securitized assets in specified proportions to aggregate outstanding investor ABS interests issued.

The seller's interest must satisfy the 5% test at the closing of each issuance of ABS interests to investors by the issuing entity, and at least monthly at a seller's interest measurement date specified under the securitization transaction documents, until no ABS interest in the issuing entity is held by any person not a wholly-owned affiliate of the sponsor.

> *Note: In determining the percentage of seller's interest at the closing of each issuance, sponsors can use a specified "as of" date or cut-off date for data about the pool's assets. This cut-off date must be no more than 60 days prior to the date of first use of the related disclosures with investors, or for securitizations with quarterly or less frequent distribution, no more than 135 days prior to the date of first use of the disclosures. A sponsor must describe its use of specified dates in its disclosures to investors.*

In the case of a revolving pool securitization that holds collateral certificates issued by another revolving pool securitization having the same sponsor, the Final Rules allow the sponsor's risk retention to be met by retaining a seller's interest for the assets represented by the collateral certificates through either revolving pool securitization. The proportion of the seller's interest retained at the level of the pool securitization that issued the collateral certificates must equal the proportion that the collateral certificates represent of the principal balance of the securitized assets of the pool securitization that issues the ABS interests as of each required measurement date.

The 5% seller's interest required on each measurement date may be reduced on a dollar-for- dollar basis by the balance, as of such date, of an excess funding account in the form of a segregated account that (i) is funded in the event of a failure to meet the minimum seller's interest requirements under the securitization transaction documents by distributions otherwise payable to the holder of the seller's interest; (ii) is invested only in the types of assets in which funds held in a horizontal cash reserve account are permitted to be invested; and (iii) in the event of an early amortization, makes payments of amounts held in the account to holders of investor ABS interests in the same manner as payments to holders of investor ABS interests of amounts received on securitized assets.

> *Note: The Final Rules have removed the requirement that the excess funding account be pari passu to each series of investor ABS interests with respect to allocation of losses.*

The Final Rules clarify that for a sponsor of a pool securitization, a reduction in the seller's interest below the percentage required by the Final Rules after the revolving pool securitization commences early amortization, pursuant to the terms of the securitization transaction documents, of all series of outstanding investor ABS interests, will not violate the sponsor's risk retention requirement if (i) the sponsor was in full compliance with its risk retention requirement on all measurement dates prior to commencement of early amortization; (ii) the terms of the seller's interest continue to make it pari passu with or subordinate in identical or varying amounts to each series of investor ABS interests issued with respect to the allocation of all distributions and losses with respect to the securitized assets; (iii) the terms of any horizontal interest relied upon by the sponsor to offset the minimum seller's interest amount continue to require the interests to absorb losses in accordance with the requirements specified by the Final Rules for the combination of a seller's interest with a horizontal interest; and (iv) the revolving pool securitization issues no additional ABS interests after early amortization is initiated to any person not a wholly-owned affiliate of the sponsor, either at the time of issuance or during the amortization period.

- *Required Disclosure*. If a sponsor of a revolving asset pool securitization elects to use the seller's interest option to satisfy the risk retention requirement, the Final Rules require that the sponsor disclose or cause to be disclosed in writing to potential investors, under the caption "Credit Risk Retention," (i) a reasonable period of time prior to the sale of the ABS interests, a description of the material terms of the seller's interest, and the percentage that the sponsor expects to retain at the closing of the securitization transaction, measured in accordance with the Final Rule as a percentage of the aggregate unpaid principal balance of all outstanding investor ABS interests issued, or as a percentage of the aggregate unpaid principal balance of outstanding investor ABS interests for one or more series issued, as required by the terms of the securitization transaction; (ii) a reasonable time after the closing of the securitization transaction, the amount of seller's interest the sponsor retained at closing, if that amount is materially different from the expected amount; (iii) a description of the material terms of any horizontal residual interests offsetting the seller's interest in accordance with the Final Rule; and (iv) disclosure of the fair value of those horizontal residual interest retained by the sponsor for the series being offered to investor and described in the disclosures, as a percentage of the fair value of the investor ABS interests issued, described in the same manner and within the same timeframes as is required for disclosure of eligible horizontal residual interests.

A sponsor must retain the required disclosures in written form in its records and must provide the disclosure upon request to the SEC and its appropriate Federal banking agency, if any, until three years after all ABS interests are no longer outstanding.

D. Asset-Backed Commercial Paper Conduits

A sponsor of an eligible asset-backed commercial paper conduit ("**eligible ABCP conduit**") that issues commercial paper that has a maturity at the time of issuance not exceeding 397 days, exclusive of days of grace ("**ABCP**"), may satisfy the risk retention requirements if each originator-seller[26] that transfers assets to collateralize the ABCP retains an economic interest in the credit risk of such assets in the same amount and manner as would be required using the standard risk retention[27] or revolving pool securitizations[28] options.

> *Note: This risk retention option is narrow in scope and would not be available to many ABCP programs, including structured investment vehicles, securities arbitrage programs and other arbitrage programs and other programs that do not satisfy the "eligible ABCP conduit" criteria.*

The Final Rules define "**eligible ABCP conduit**" as an entity that issues ABCP meeting each of the following criteria:

1. The ABCP conduit is bankruptcy remote or otherwise isolated for insolvency purposes from the sponsor and from any intermediate SPV from which it acquires any ABS interest.

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26 "**Originator-seller**" means an entity that originates assets and sells or transfers those assets, directly or through a majority-owned affiliate, to an intermediate SPV, and includes (except for the purposes of identifying the sponsorship and affiliation of an intermediate SPV pursuant to this option) any affiliate of the originator-seller. For purposes of this definition, "majority control" means ownership of more than 50% of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under U.S. GAAP.

"**Intermediate SPV**" means a special purpose vehicle that: (1)(i) is a direct or indirect wholly-owned affiliate of the originator-seller; or (ii) has nominal equity owned by a trust or corporate service provider that specializes in providing independent ownership of special purpose vehicles, and such trust or corporate service provider is not affiliated with any other transaction parties; (2) is bankruptcy remote or otherwise isolated for insolvency purposes from the eligible ABCP conduit and from each originator-seller and each majority-owned affiliate in each case that, directly or indirectly, sells or transfers assets to such intermediate SPV; (3) acquires assets from the originator-seller that are originated by the originator-seller or acquired by the originator-seller in the acquisition of a business that qualifies for business combination accounting under U.S. GAAP or acquires asset-backed securities ("**ABS**") interests issued by another intermediate SPV of the originator-seller that are collateralized solely by such assets; and (4) issues ABS interests collateralized solely by such assets, as applicable.

27 See Part V.A. above: Standard Risk Retention.

28 See Part V.C. above: Revolving Pool Securitizations (Seller's Interest).

2. The ABS interests acquired by the ABCP conduit are:

   (i) ABS interests collateralized solely by assets originated by an originator-seller and by servicing assets:

   (ii) Special units of beneficial interests (or similar ABS interests) in a trust or special purpose vehicle that retains legal title to leased property underlying leases originated by an originator-seller that were transferred to an intermediate SPV in connection with a securitization collateralized solely by such leases and by servicing assets;

   (iii) ABS interests in a revolving pool securitization collateralized solely by assets originated by an originator-seller and by servicing assets;

   (iv) ABS interests described in paragraphs (i), (ii) or (iii) above that are collateralized, in whole or in part, by assets acquired by an originator-seller in a business combination that qualifies for business combination accounting under U.S. GAAP, and, if collateralized in part, the remainder of such assets are assets described in paragraphs (i), (ii), or (iii) above, or

   (v) Acquired by the ABCP conduit in an initial issuance by or on behalf of an intermediate SPV (A) directly from the intermediate SPV, (B) from an underwriter of the ABS interests issued by the intermediate SPV, or (C) from another person who acquired the ABS interests directly from the intermediate SPV;

> *Note: Paragraph (2) above clarifies that the assets being financed have been originated by the originator-seller and not purchased and aggregated. In general, eligible ABCP conduits may not purchase ABS interests in the secondary market; provided, however, that at any time, an eligible ABCP conduit that acquired an ABS interest in accordance with this option may transfer to another eligible ABCP conduit if (x) the sponsors of both eligible ABCP conduits are in compliance with this option and (y) the same regulated liquidity provider has entered into one or more commitments to provide 100% liquidity coverage to all the ABCP issued by both eligible ABCP conduits.*

> *Note: ABCP conduits may have different regulated liquidity providers and, if they do, it is unclear why, in order to transfer ABS interests between eligible ABCP conduits, that the same regulated*

liquidity provider must provide 100% liquidity to both eligible ABCP conduits, especially when a regulated liquidity provider already covers 100% of the credit risk, well above the requisite risk retention already retained by the originator-seller required by the Final Rules.

3. The ABCP conduit is collateralized solely by ABS interests acquired from intermediate SPVs as described in paragraph (2) above of this definition and servicing assets.

   Note: Not all ABCP conduits utilize the intermediate SPV structure. This provision also prohibits intermediate SPVs from acquiring assets from non-affiliates or in the secondary market, except as provided in the second note above.

4. A regulated liquidity provider[29] has entered into a legally-binding commitment to provide 100% liquidity coverage (in certain specified forms) to all the ABCP issued by the ABCP conduit by lending to, purchasing ABCP issued by, or purchasing assets from, the ABCP conduit in the event that funds are required to repay maturing ABCP issued by the ABCP conduit. With respect to the 100% liquidity coverage, in the event that the ABCP conduit is unable for any reason to repay maturing ABCP issued by it, the liquidity provider must be obligated to pay an amount equal to any shortfall, and the total amount that may be due pursuant to the 100% liquidity coverage must be equal to 100% of the amount of the ABCP outstanding at any time plus accrued and unpaid interest (amounts due pursuant to the required liquidity coverage may not be subject to credit performance of the ABS interests held by the ABCP conduit or reduced by the amount of credit support provided to the ABCP conduit and liquidity support that only funds performing loans or receivables or performing ABS interests does not meet the requirements of the eligible ABCP conduits section of the Final Rules).

   Note: Not all ABCP conduits have 100% liquidity coverage and, if they do, it is not clear why a "regulated" (as defined in the Final Rules) liquidity provider is required so long as such provider has a high enough credit standing.

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[29] "**Regulated liquidity provider**" means: (1) a depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)); (2) a bank holding company (as defined in 12 U.S.C. 1841), or a subsidiary thereof; (3) a savings and loan holding company (as defined in 12 U.S.C. 1467a), provided all or substantially all of the holding company's activities are permissible for a financial holding company under 12 U.S.C. 1843(k), or a subsidiary thereof; or (4) a foreign bank whose home country supervisor (as defined in § 211.21 of the Federal Reserve Board's Regulation K (12 CFR 211.21)) has adopted capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision, as amended, and that is subject to such standards, or a subsidiary thereof.

Note: Not all ABCP conduits have liquidity coverage that covers the credit risk of the ABS held by the ABCP conduit and it is unclear why the Federal banking agencies would want the regulated provider to cover 100% of the credit risk when the originator-seller already covers the requisite risk retention required by the Final Rules.

Note: If the ABCP conduit does not satisfy the "eligible ABCP conduit" criteria, the sponsor must retain credit risk in accordance with another risk retention option included in the Final Rules (unless an exemption for the transaction exists).

- *Responsibility for Compliance*. The Final Rules would require the sponsor of an eligible ABCP conduit that issues ABCP in reliance on this risk retention option to be responsible for compliance with the requirements of this option. The sponsor must maintain policies and procedures to monitor compliance by each originator-seller which is satisfying a risk retention obligation in respect of ABS interests acquired by an eligible ABCP conduit with the requirements of this option and must (A) promptly notify investors, and upon request, the SEC and its appropriate Federal banking agency, if any, in writing of: (1) the name and form of organization of any originator-seller that fails to retain risk in accordance with this option and the amount of ABS interests issued by an intermediate SPV of such originator-seller and held by the ABCP conduit; (2) the name and form of organization of any originator-seller that hedges, directly or indirectly through an intermediate SPV, its risk retention in violation of this option and the amount of ABS interests issued by an intermediate SPV of such originator-seller and held by the ABCP conduit; and (3) any remedial actions taken by the ABCP conduit sponsor or other party with respect to such ABS interests; and (B) take other appropriate steps pursuant to the requirements of this option which may include, as appropriate, curing any breach of the requirements of this option, or removing from the eligible ABCP conduit any ABS interest that does not comply with the requirements of this option. The sponsor would be required to (i) establish criteria governing the ABS interests, and the securitized assets underlying the ABS interests, acquired by the ABCP conduit, (ii) approve (1) all originator-sellers and (2) each intermediate SPV from which an eligible ABCP conduit is permitted to acquire ABS interests, and (iii) administer the ABCP conduit and maintain and adhere to policies and procedures for ensuring that all requirements have been met (including policies and procedures that are reasonably designed to monitor compliance by each originator-seller which sells assets to the eligible ABCP conduit with the applicable risk retention requirements).

Note: The terms and conditions of the eligible ABCP conduit risk retention option are designed to ensure that the assets of "eligible ABCP conduits" have low credit risk and that originator-sellers have incentives to monitor the quality of such assets. However, sponsors may have difficulty monitoring compliance by the originator-sellers with the requirements of this option.

- Required Disclosure. Sponsors must disclose (A) the name and form of organization of each regulated liquidity provider that provides liquidity support to the eligible ABCP conduit (including a description of the material terms of such liquidity coverage) and (B) with respect to each ABS interest held by the ABCP conduit: (i) the asset class or brief description of the underlying securitized assets; (ii) the standard industrial category code (SIC Code) for the originator-seller that will retain (or has retained), pursuant to the eligible ABCP conduit option, an interest in the securitization transaction; and (iii) a description of the percentage amount of risk retention pursuant to the rule by the originator-seller, and whether it is in the form of an eligible horizontal residual interest, vertical interest, or revolving pool securitization seller's interest, as applicable. Each of the foregoing items of disclosure must be as of a date not more than 60 days prior to the date of first use with investors. In addition, an ABCP conduit sponsor relying upon the eligible ABCP conduit option shall provide, or cause to be provided, upon request, to the SEC and its appropriate Federal banking agency, if any, in writing, all of the information required to be provided to investors in the preceding sentence, and the name and form of organization of each originator-seller that will retain (or has retained), pursuant to this option, an interest in the securitization transaction.

Note: As is customary in the ABCP market, the names of any originator-seller are not required to be disclosed to investors under the Final Rules. However, under the eligible ABCP conduit option, the sponsor must promptly notify investors, and upon request, the SEC and its appropriate Federal banking agency, if any, of the name of any originator-seller that fails to retain risk in accordance with this option or hedges its risk retention in violation of this option.

E. Treatment of Governmental Sponsored Entities

Guarantees provided by Fannie Mae or Freddie Mac (each, a "**GSE**") while operating under the conservatorship or receivership of the FHFA with capital support from the United States will satisfy the risk retention requirements of such GSE with respect to ABS issues if the guarantee is of the timely payment of principal and interest on all ABS interests issued by the issuing entity. The Agencies note that because the GSEs fully guarantee the timely payment of principal and interest on their ABS, GSEs are already exposed to the entire credit risk of the mortgages backing those ABS. An equivalent guaranty provided by a limited life regulated entity that has succeeded to the charter of a GSE and that is operating under the direction and control of the FHFA with capital support from the United States will also satisfy the risk retention requirements. If either GSE or limited-life regulated entity begins to operate other than under the conservatorship or receivership of the FHFA, such GSE or entity will no longer be able to avail itself of this option.

- *Required Disclosure*. A GSE satisfying its risk retention obligations under this alternative would be required to disclose to investors and, upon request, to the FHFA, a description of the manner in which it has met its credit risk retention requirement.

Note: With respect to certain ABS sponsored by the GSEs, only a portion of the related securities are fully guaranteed, with the balance of the securities (generally a relatively small junior interest) not having the benefit of any GSE guaranty. Guidance from the Agencies is needed on whether risk retention requirements would apply in any such circumstance, and if so, how the required retention should be calculated.

Note: With respect to certain ABS sponsored by third parties, the GSEs will sometimes acquire the senior tranche and then sponsor a fully guaranteed ABS collateralized by that senior tranche, while the third-party sponsor sells the unguaranteed junior tranche (which is relatively small) to investors. The GSE-guaranteed ABS would presumably be exempt from credit risk retention because it is the only ABS-interest in the related issuing entity. However, a question arises as to whether the third-party sponsor of the issuing entity that issued both the senior tranche that collateralizes the GSE's guaranteed ABS and the unguaranteed junior tranche should be required to hold a retained interest based on the fair value of both ABS interests or just the junior tranche.

Note: The Agencies noted the ongoing efforts to reform the operations of the GSEs and expressed an intent to revisit and, if appropriate, modify the provisions of the Final Rules applicable to the GSEs once the future of their statutory and regulatory framework become clearer.

F. CLOs

General

Notwithstanding the extensive commentary received by the Agencies on the Reproposed Rules, the Final Rules, as they relate to CLOs, are largely identical to the Reproposed Rules. As discussed in more detail below, the Final Rules provide two options for risk retention for CLOs[30, 31]: (i) CLO Manager risk retention (by itself or through a majority-owned affiliate) and (ii) CLOs composed exclusively of CLO-eligible loan tranches that otherwise meet the "lead arranger" risk retention criteria. In the Preamble, the Agencies make the following observations:

- *Open Market CLOs*. The Agencies believe the Final Rules place risk retention responsibility on the parties most capable of ensuring and monitoring the credit quality of the assets collateralizing open market CLOs – *i.e.*, the CLO Manager or the lead arranger of the underlying loans. The Agencies believe that these two options will (i) promote discipline in the underwriting standards for loan assets being securitized and (ii) reduce the risk that such loans pose to financial stability.

> *Note: The Agencies' concern with promoting such discipline and reducing such risk appears to be an outgrowth of what they see as recent developments in the leveraged loan market. The Agencies note that "[h]eightened activity in the leveraged loan market has been driven by search for yield and a corresponding risk appetite by investors" and that evidence exists of a "widespread loosening of underwriting standards" that coincides with such activity.*[32]

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30 The Agencies state in the preamble accompanying the Final Rules (the "**Preamble**") that they believe it is appropriate to require risk retention for both open market CLOs and balance sheet CLOs. The Agencies note that many commentators to the Reproposed Rules raised a variety of concerns about the application of the risk retention requirements to open market CLOs. Although open market CLOs of broadly syndicated loans account for most of the new issuance activity in the CLO market today, we note that the Final Rules preserve from the Reproposed Rules a provision that permits risk retention by the "originator" of one or more securitized assets that acquires its eligible interest from the sponsor, which acquisition may offset the amount of the sponsor's risk retention requirements. This provision may have particular value for non-bank middle-market originators and private loan funds that use balance sheet CLOs for long-term financing of their loan portfolios and business platforms. It is not yet clear whether new origination structures can be created such that open market CLOs of broadly syndicated loans also would be able to use this mechanism for satisfying the risk retention requirements.

31 The Final Rules include an exemption from the risk retention requirements (largely unchanged from the Reproposed Rules) for static securitizations of "qualifying commercial loans" (*i.e.*, loans that meet specified underwriting criteria) that meet certain requirements. Although this exemption is theoretically available to CLOs, as a practical matter few (if any) CLOs structured in the market today would be able to satisfy these requirements.

32 See pp. 201-202 and 230 of the Preamble.

- *CLO Manager as Securitizer*. The Agencies confirm their belief that a CLO Manager is clearly included within the definition of "securitizer" under Section 15G of the Exchange Act[33] because the CLO Manager is the person who "organizes and initiates" a CLO by (1) selecting the commercial loans to be purchased by the CLO issuing entity, (2) directing such issuing entity to purchase such loans in accordance with specified investment guidelines and (3) then, managing the securitized loans on behalf of the CLO. As a result, the CLO Manager is subject to the risk retention requirements of the Final Rules.[34]

In addition, as discussed in Part II of this memo, the Final Rules remove the proposed cash flow restrictions on payments to an eligible horizontal residual interest retained by a sponsor. This change from the Reproposed Rules is particularly significant for CLOs, since compliance with such restrictions was seen by the market as commercially unfeasible, given that investors in the "equity tranche" of a CLO require that excess interest spread be paid to them in accordance with the CLO's priority of payments on a current basis.

- *Impact on the CLO Market*.

  Agencies' Perspective – The Agencies acknowledge that requiring open market CLO Managers to satisfy the risk retention requirement under the Final Rules could result in fewer CLO issuances and less competition in the CLO market.[35] In this regard, the Agencies make the following observations:[36]

  - Other entities, such as hedge funds and loan mutual funds, also purchase commercial loans; the market will "adjust" to the Final Rules; and "lending to creditworthy commercial borrowers, on appropriate terms, will continue at a healthy rate."

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33 The Volcker Rule incorporates the definition of "securitizer" under the Final Rules. As a result, a CLO Manager that is a "banking entity" for purposes of the Volcker Rule will need to consider the implications of such rule to the extent that the related CLO it manages is a "covered fund." See the discussion of "Sponsor" in Part IV.A of this memo.

34 The Agencies also disagree with commentators' assertions that Congress intended Section 15G to apply primarily to securitizations within the originate-to-distribute model. The Agencies note that Section 15G specifies that retention applies to all securitizers unless they have a specific exemption under the statute or the Agencies provide a specific exemption in accordance with criteria set forth in the statutory text. See 15 U.S.C. 78o-11(b)(1) ("[T]he Federal banking agencies and the Commission shall jointly prescribe regulations to require any securitizer to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party."), which is cited in footnote 167 of the Preamble. See, also, 15 U.S.C. 78o-11(c)(1)(G)(i) and 15 U.S.C. 780-11(e).

35 See pp. 229-230 of the Preamble.

36 See p. 230 of the Preamble.

- The projected impacts on the CLO market identified by commentators are justified by the benefits that will be produced by subjecting open market CLOs to the risk retention rules.
- The CLO Manager and lead arranger options provide sufficient flexibility to avoid significant disruptions to the CLO and credit markets.

Market's Perspective – Market participants are still analyzing the Final Rules and the impact such rules will have on the CLO market going forward. After considering the Final Rules and obtaining preliminary feedback from market participants, we offer the following observations on the potential consequences of risk retention on open market CLOs:

- *"Lead Arranger" Retention Option*. Market feedback has been that the lead arranger option will not be widely adopted (if at all) by arranging banks of commercial loans. As a result, the only viable form of risk retention for open market CLOs will be retention by the CLO Manager or a majority-owned affiliate thereof. Market participants are, however, considering possible originator structures as a means of satisfying all or a portion of the required 5% retention amount.

  > *Note: The use of the originator structure for open market CLOs may prove very challenging. Under a plain reading of the Final Rules, it should be quite simple to set up a warehousing entity that "initiates the securitization by transferring" loans to the CLO. However, the Agencies went to great lengths to explain that the sponsor of a CLO needs to be the entity responsible for loan credit selection, which seems to be only the true, original lender of the loans or the CLO Manager that is selecting the loans.*[37]

- *CLO Managers*. If CLO Manager retention remains the only viable form of retention for open market CLOs, general market consensus is that the number of CLO Managers that are able to issue new CLOs will decrease.[38] CLO Managers wishing to continue issuing new transactions (or, as discussed more fully below, to comply with the risk retention requirements that may apply to otherwise grandfathered CLOs) will need to

[37] The originator structure will be a more viable solution to satisfy all or a portion of the risk retention requirements for middle-market CLOs. See footnote 29 above.

[38] The Agencies note that many who commented on the Reproposed Rules asserted that imposing standard risk retention requirements could cause CLO Managers to exit the market or be acquired by larger CLO Managers. If the commenters prove to be correct, the CLO market could see consolidation among CLO Managers and, consequently, as the Agencies acknowledge, fewer CLO issuances and less competition in the market. See pp. 203, 207-208 and 229-230 of the Preamble.

access additional capital, either directly or through a majority-owned affiliate, to finance their future retention requirements.

> *Note: As needed, CLO Managers are expected to work with their accountants to create structures that permit investors to participate in, and help fund, such CLO Managers' risk retention requirements via a majority-owned affiliate. Whether such structures are considered a majority-owned affiliate of the CLO Manager under the Final Rules will be a function of whether "majority control" exists as determined in accordance with GAAP. In this regard, we note that the control rules under GAAP are in the process of being republished. Hence, structures being considered will need to take this into consideration. We also note that if at any point during the required retention period the affiliate is no longer considered to be "majority-owned" as described above, the CLO Manager will technically no longer be in compliance with the risk retention requirements.*

- <u>CLO Issuance</u>. *Pre-Effective Date* – As discussed below, CLOs whose closing dates occur prior to the effective date of the Final Rules generally will be grandfathered. As a result, CLO Managers and arranging banks could be expected to close as many open market CLOs as market conditions permit before the risk retention rules take effect. However, CLO Managers without an effective strategy to finance their long-term business operations (including financing any future required risk retention obligations) after the effective date of the Final Rules may encounter headwinds prior to such date in marketing their transactions. In addition, as discussed below under "Application to Grandfathered Deals," CLO issuance may be adversely impacted by the potential consequence the risk retention rules may have on the ability of CLOs to effect additional issuances, refinancings and/or re-pricings. Due to such uncertainties, certain changes to CLO transaction documents (including with respect to reinvestment and amendment provisions) should be considered in structuring new transactions that will close before the effective date of the Final Rules.

  Post-Effective Date – It is too early to definitively say how issuance of open market CLOs will be impacted by the Final Rules, given that market participants need a period of time to fully analyze and adjust their businesses and market practices in response to such rules. However, unless material forms of capital can be raised by CLO Managers to finance their retention requirements and/or novel originator structures that are compliant with the Final Rules are created, overall issuance of open market CLOs may be materially lower than it is today.[39]

- *Application to Grandfathered Deals*. The Final Rules will become effective on the date that is two years after publication thereof in the Federal Register. Even though CLOs typically have long lives due to their ability to reinvest principal proceeds in additional or substitute assets, a CLO generally will be "grandfathered" from the risk retention requirements so long as its closing date occurs prior to the effective date for the Final Rules. However, many CLOs include features, typically exercisable at the option of the holders of a majority of the "equity tranche" of the CLO, that permit the issuance of additional notes of one or more CLO tranches and the refinancing and/or re-pricing of one or more rated CLO tranches from time to time, subject to specified conditions. The exercise of these features would involve, except arguably in the case of certain refinancings and re-pricings, "the offer and sale of asset-backed securities by an issuing entity" and thus constitute a "securitization transaction" in respect of which the risk retention requirements of the Final Rules must be satisfied by the CLO Manager (as the "sponsor" of the securitization).

> *Note: A strong argument can be made that a CLO Manager should not be deemed to be a sponsor under the Final Rules for purposes of triggering risk retention with respect to a grandfathered CLO, solely by virtue of the issuance (or deemed issuance) of securities over which the CLO Manager has no direct control.*
>
> *Note: Although not clear from the language of the Final Rules, it may be possible that a refinancing or re-pricing could be effected in such a way (such as refinancing one or more outstanding CLO tranches with the proceeds of a loan or re-pricing one or more outstanding CLO tranches through a supplemental indenture, in either case without the issuance of new or replacement notes) that such action would not, in and of itself, cause the sponsor of a grandfathered CLO to be subject to the risk retention requirements under the Final Rules.*

If the risk retention requirements of the Final Rules are determined to apply to otherwise grandfathered CLOs, as the result of the exercise of additional issuance, refinancing or re-pricing features, market participants will need to consider a number of issues. For example, CLO Managers generally do not have specific approval or veto rights in

[39] See *The CLO Salmagundi: Risk Retention*, Wells Fargo Research (Dave Preston and Jason McNeilis), October 21, 2014.

respect of refinancings or re-pricings (although CLO Managers may have rights to approve supplemental indentures entered into in order to effect such actions; and most CLO indentures generally prohibit the issuer from entering into a supplemental indenture that would have a material adverse effect on the CLO Manager without its consent). Given the potential application of the risk retention rules and the related consequences for a CLO Manager that would result from the exercise of any such feature, CLO indentures for transactions that will close prior to the effective date of the Final Rules will need to be expanded in order to permit compliance with the Final Rules, if such compliance is determined to be necessary and acceptable to the CLO Manager.

- *Financing of Retention Interest*. The Final Rules do not prohibit a sponsor (or a majority-owned affiliate of the sponsor) from financing the acquisition of its retention interest in a securitization transaction. However, the Final Rules do prohibit a sponsor and its affiliates from pledging as collateral for any obligation any interest that the sponsor is required to retain unless such obligation is with full recourse to the sponsor or its affiliate, as applicable.

  Hence, a CLO Manager (or its majority-owned affiliate) generally may be able to borrow (directly or indirectly through its parent) in order to fund the acquisition of a retention interest mandated by the risk retention requirements, but the financing must be on a full recourse basis if the retention interest is pledged as collateral for such financing. This raises an interesting question of what the consequences would be to a sponsor if a lender attempted to foreclose on the retention interest held by a CLO Manager (or its majority-owned affiliate). Although the Final Rules do not expressly address the foreclosure of a pledged retained interest, in its commentary on the Reproposed Rules the Agencies stated that, where a pledge of an interest or asset to support full recourse financing subsequently results in such interest or asset being taken by the counterparty to the financing transaction (whether by consent, pursuant to exercise of remedies or otherwise), the sponsor will be viewed as having violated the prohibition on transfer.[40] The foregoing suggests that any retention interest financing arrangements by a CLO Manager (or its affiliate) should not permit foreclosure on such retention interest until the expiration of the related retention period.

  > *Note: In Europe, for purposes of compliance with Article 405 of the Capital Requirements Regulation, financing of a retention interest in a CLO by an eligible retention holder is not uncommon. Article 12(2) of Commission Delegated Regulation (EU) No 625/2014 of 13 March 2014 provides that the retainer may use any retained exposures or securitization positions as collateral for*

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40 See p. 174 of the preamble accompanying the Reproposed Rules.

secured funding purposes, as long as such use does not transfer the credit risk of these retained exposures or securitization positions to a third party. In light of the requirement that the use of any retained exposures or securitization positions does not transfer the credit risk to a third party, these financing arrangements are typically on a full recourse basis. Such arrangements may involve a guaranty by the borrower's parent and typically involve financing a portion of the vertical interest represented by the investment grade tranches and, potentially, below investment grade tranche(s), of the related CLO. If a lender enforces its security interest in the retention notes, the related CLO will no longer be compliant with Article 405 of the Capital Requirements Regulation.[41]

Note: It is anticipated that certain lenders will attempt to develop arrangements to facilitate CLO Managers' financing of their required retention interests in open market CLOs. As we've seen in European CLO transactions, such arrangements will likely involve financing a vertical interest in a CLO. The question remains whether the terms of any such arrangements will be offered on sufficiently attractive terms or whether such arrangements will afford sufficient credit capacity to be a viable source of funding to CLO Managers to finance their future retention requirements.

- *Jurisdictional Scope*. – Non-US ABS transactions, including European CLOs, may trigger risk retention under the Final Rules unless the transaction comes within the safe harbor for foreign-related transactions. See "Foreign Transaction Safe Harbor" in part VII.C of this memo for a summary of the technical requirements of the safe harbor rule. The key prong of the safe harbor that might cause US risk retention rules to apply to a European CLO is the requirement that no more than 10% of the dollar value of classes of ABS securities (based on "fair value") of a transaction are sold to "US persons"[42] in the related offering. Resales of ABS securities to US persons in the secondary market will not count towards this 10% requirement.

  Note: It is unclear at this point what the consequences will be for a non-US ABS transaction that does not meet all of the technical

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41 See, generally, *EU Risk Retention Requirement: A workable solution for US CLO collateral managers?*, January 23, 2014, at http://www.cadwalader.com/resources/clients-friends-memos/eu-risk-retention-requirement-a-workable-solution-for-us-clo-collateral-managers.

42 "US person" is defined under the Final Rules and is consistent with the definition of "U.S. Person" set forth in Regulation S promulgated under the U.S. Securities Act of 1933, as amended.

requirements of the foreign transaction safe harbor. The sponsor (i.e., a CLO Manager in the case of an open market CLO) is responsible for retention compliance under the Final Rules. The consequences to a particular sponsor will depend in part on the what authority the Agencies may have over such sponsor. Note: The foreign transaction safe harbor would not be available with respect to any transaction or series of transactions that, although in technical compliance with the safe harbor, is part of a plan or scheme to evade the requirements of Section 15G and the Final Rules. In such cases, compliance with Section 15G and the Final Rules would be required.

- *Compliance with Non-US Risk Retention Requirements.* The Agencies make clear in the Preamble that compliance with European or other non-US forms of ABS credit risk retention will not satisfy US risk retention under Section 15G of the Exchange Act.[43]

- *Resignation/Removal of the CLO Manager*. CLO management agreements permit the CLO Manager to resign upon prior notice to the issuer and also provide for the removal of the CLO Manager under certain circumstances at the direction or with the consent of one or more specified classes of CLO securities. Although the Final Rules contain certain restrictions on hedging, financing and transferring retention interests, they do not directly address what the resignation or removal of a CLO Manager means for any retention interest previously acquired by such CLO Manager in satisfaction of its risk retention requirements as sponsor of a CLO.

Note: Should a successor CLO Manager be required, as a condition to its appointment, to acquire the retention interest held by a CLO Manager that is resigning or being removed? In the Preamble, the Agencies emphasize the importance of promoting discipline in the underwriting standards of loans being securitized, monitoring the credit quality of CLO collateral and ensuring that the interests of CLO Managers are adequately aligned with CLO investors.[44] Such statements suggest that Section 15G may require a successor CLO Manager to acquire the outgoing CLO Manager's retention interest as a condition to its appointment,

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[43] See pp. 274-275 of the Preamble. An open question is whether it is possible to create a structure that qualifies as an "originator" for purposes of satisfying European risk retention requirements, but also can be treated as the "majority-owned affiliate" of a CLO Manager for purposes of satisfying US risk retention requirements.

[44] See, variously, pp. 201, 220, 223-4 and 231 of the Preamble.

particularly if new loan assets may be acquired by the CLO after such appointment.

Note: Additional guidance from the Agencies likely will be required to clarify how risk retention is satisfied in the context of the resignation or removal of a CLO Manager. We note that the European risk retention rules also do not address this point but we anticipate some guidance from the European Banking Authority over the next few months.

- <u>*Open Market CLOs and the "Lead Arranger" Option*</u>. Set out below is a summary of the Final Rules for "**Open Market CLOs**" (as defined below) and the "lead arranger" option for satisfying the risk retention requirements. The primary differences from the Reproposed Rules are: (1) the disclosures required to be made by sponsors in connection with Open Market CLOs have been slightly expanded; and (2) the certifications required to be made by the lead arranger and the CLO Manager have been revised to be more in line with those required of depositors with respect to QRMs and other qualifying asset classes.

Note: As discussed above, the widespread view of market participants is that the lead arranger option is not workable for banks that arrange loans to commercial borrowers.

A sponsor satisfies its risk retention requirements with respect to Open Market CLOs (as defined below) that purchase and hold only "CLO-eligible loan tranches" (as defined below). The Lead Arranger (as defined below) of each loan in the CLO-eligible loan tranche must retain at least 5% of the face amount of the term loan tranche purchased by the CLO until repayment, maturity, acceleration, payment default or bankruptcy. The Final Rules further require, among other things, that the Lead Arranger of the underlying loan must take an initial allocation of at least 20% of the face amount of the broader syndicated credit facility, and no other member of the syndicate could take a larger share.

Note: The rationale for this provision appears to be that the Agencies believe holding the largest allocation of the credit facility will provide the Lead Arranger with significant influence over the negotiation of the loan terms.

The Final Rules define an "**Open Market CLO**" as a CLO (1) whose assets consist of senior, secured syndicated loans acquired by such CLO directly from the sellers thereof in Open Market Transactions and of servicing assets, (2) that is managed by a CLO Manager, and (3) that holds less than 50% of its assets, by aggregate outstanding principal amount, in loans syndicated by lead arrangers that are affiliates of the CLO or the CLO Manager or originated by originators that are affiliates of the CLO or the CLO Manager.

To qualify under this alternative risk retention proposal, such Open Market CLO must meet the following criteria:

- It may acquire and hold only CLO-eligible loan tranches and servicing assets.
- Its governing documents require it, at all times, to own only Senior, Secured Syndicated Loans that are CLO-eligible loan tranches (and servicing assets).
- It may not invest in ABS interests or in credit derivatives (other than hedging transactions that are servicing assets to hedge its payment risks).
- It may purchase assets only in Open Market Transactions on an arm's-length basis.
- Its CLO Manager is not entitled to receive any management fee or gain on sale at the time the CLO issues its notes.

The Final Rules define an "**Open Market Transaction**" as either (1) an initial loan syndication transaction or a secondary market transaction in which a seller offers Senior, Secured Syndicated Loans to prospective purchasers in the loan market on market terms on an arm's-length basis, which prospective purchasers include, but are not limited to, entities that are not affiliated with the seller, or (2) a reverse inquiry from a prospective purchaser of a Senior, Secured Syndicated Loan through a dealer in the loan market to purchase a Senior, Secured Syndicated Loan to be sourced by the dealer in the loan market.

The Final Rules define a "**Senior, Secured Syndicated Loan**" as a loan made to a commercial borrower that: (1) is not subordinate in right of payment to any other obligation for borrowed money of the commercial borrower; (2) is secured by a valid first priority security interest or lien in or on specified collateral securing the commercial borrower's obligations under the loan; and (3) the value of the collateral subject to such first priority security interest or lien, together with other attributes of the obligor (including, without limitation, its general financial condition, ability to generate cash flow available for debt service and other demands for that cash flow), is adequate (in the commercially reasonable judgment of the CLO Manager exercised at the time of investment) to repay the loan and to repay all other indebtedness of equal seniority secured by such first priority security interest or lien in or on the same collateral, and the CLO Manager certifies, on or prior to each date that it acquires a loan constituting part of a new CLO-eligible tranche, that it has policies and procedures to evaluate the likelihood of repayment of loans acquired by the CLO and it has followed such policies and procedures in evaluating each CLO-eligible loan tranche.

> *Note: This is substantially identical to the standard senior secured loan definition currently used by most CLOs.*

The Final Rules define a "**CLO-eligible loan tranche**" as a term loan tranche of a syndicated loan that at all times meets the following criteria:

- A minimum of 5% of the face amount of the CLO-eligible loan tranche is retained by the Lead Arranger thereof until the earliest of the repayment, maturity, involuntary and unscheduled acceleration, payment default, or bankruptcy default of such CLO-eligible loan tranche. Such 5% interest must be retained un-hedged in accordance with the same anti-hedging, transferring and pledging restrictions that apply to ABS risk retention, as discussed above.
- The lender voting rights within the credit agreement and any intercreditor or other applicable agreements governing such CLO-eligible loan tranche are defined so as to give holders of the CLO-eligible loan tranche consent rights with respect to, at minimum, any material waivers and amendments of such applicable documents, including but not limited to, adverse changes to the calculation or payments of amounts due to the holders of the CLO-eligible tranche, alterations to pro rata provisions, changes to voting provisions, and waivers of conditions precedent.
- The *pro rata* provisions, voting provisions, and similar provisions applicable to the security associated with such CLO-eligible loan tranches under the CLO credit agreement and any intercreditor or other applicable agreements governing such CLO-eligible loan tranches are not materially less advantageous to the holder(s) of such CLO-eligible tranche than the terms of other tranches of comparable seniority in the broader syndicated credit facility.

The Final Rules define "**Lead Arranger**" as an institution that:

- is active in the origination, structuring and syndication of commercial loan transactions and has played a primary role in the structuring, underwriting and distribution in the primary market of the CLO-eligible loan tranche;

- has taken an allocation of the funded portion of the syndicated credit facility under the terms of the transaction that includes the CLO-eligible loan tranche of at least 20% of the aggregate principal balance at origination, and no other member (or members affiliated with each other) of the syndication group that funded at origination has taken a greater allocation;

> *Note: This allocation requirement could preclude all but a handful of the largest banks with respect to very large loan facilities.*

- is clearly identified in the credit agreement of the CLO-eligible tranche;
- represents in the credit agreement that such Lead Arranger satisfies the requirements in the first paragraph of this definition and at the time of initial funding will satisfy the requirements in the second paragraph of this definition, and further represents that in its reasonable judgment, the terms of such CLO-eligible loan tranche are consistent with the requirements of the second and third paragraphs of the definition of "CLO-eligible loan tranche"; and
- covenants in the credit agreement to undertake the required 5% retention as set forth in the first paragraph of the definition of CLO-eligible loan tranche.

G. Tender-Option Bonds

Tender option bonds ("**TOBs**") involve the creation of a trust that holds municipal securities (typically a single series of a highly rated, tax-exempt municipal bond), and the issuance by the trust of two classes of certificates. One class distributes interest based on a floating rate (the "floaters"); the other class distributes interest based on the inverse of the floating rate security (the "residuals"). The structure is designed to pass through the interest on the municipal securities to the floaters and residuals on a tax-exempt basis and to allow the floaters to be eligible for investment by money market funds.

The holders of the floaters have the right to tender their floaters for purchase at par plus accrued interest, and the payment of the tender price is supported by a liquidity facility delivered by a highly rated provider. Upon the occurrence of a default or bankruptcy of the municipal bond issuer, a downgrade of the bond below investment grade, or certain events adversely affecting the tax-exempt status of the bond (each such event, a "tender option termination event"), each class suffers a loss based on then-current market price of the bond.

> *Note: While tender option bond issuing entities created prior to effective date of the Final Rules are exempt from the risk retention requirements of the Final Rules, the Agencies have clarified that if a*

pre-existing tender option bond issuing entity issues additional securities after the effective date of the Final Rules, then notwithstanding the fact that the issuing entity was formed prior to the effective date of the Final Rules, the sponsors of the issuing entity would be subject to the risk retention requirements with respect to the new issuance of bonds.

The Final Rules would allow a "sponsor" of a "qualified tender option bond entity" to use the standard risk retention methods described in Part III.A above, including holding an eligible vertical interest, an eligible horizontal interest, or any combination thereof. The sponsor may retain an eligible horizontal residual interest at issuance that is subsequently converted into an eligible vertical interest upon the occurrence of a "tender option termination event." The sponsor may also satisfy the risk retention requirement by holding municipal securities from the same issuance deposited into the qualified tender option bond entity in an amount equal to 5% of the face value of the municipal securities deposited. Finally, the sponsor may satisfy the risk retention requirement by holding any combination of the foregoing interests or securities such that the sum of the percentages held in each form equals at least 5%. The fair value of the tender option bonds are calculated as of the closing date; provided that, if the tender option bond issuing entity issues additional tender option bonds after the closing date, the sponsor must recalculate the fair value of the tender option bonds as of the date of the subsequent issuance.

Note: The Final Rules provide that the Agencies believe that a residual interest in a qualified tender option bond entity would meet the requirements of an eligible horizontal residual interest before, and an eligible vertical interest after, the occurrence of a tender option termination event if: (i) prior to the occurrence of a tender option termination event, the residual holder bears all the market risk associated with the underlying tax-exempt municipal security; and (ii) after the occurrence of a tender option termination event, any credit losses are shared pro rata between the tender option bonds and the residual interest.

The Final Rules define "qualified tender option bond entity" as an entity that issues 'tender option bonds" and meets criteria that include:

- The issuing entity must be collateralized solely by servicing assets and municipal securities that have the same issuer and the same underlying obligor or source of payment (determined without regard to third-party credit enhancement).

- The terms of all securities issued by the entity must be structured such that all holders of securities who are eligible exclude interest received on such securities will be able to exclude that interest from gross income or, in the case of regulated investment companies, treat such interests as exempt interest dividends.
- A regulated liquidity provider (as defined in Part III.D of this memo) must have entered into a legally-binding commitment to provide 100% liquidity coverage to all outstanding tender option bonds issued by the issuing entity.
- The issuing entity must qualify for monthly closing elections pursuant to IRS Revenue Procedure 2003-84, as amended or supplemented from time to time.

The Final Rules define a "tender option bond" as a security that has features which entitle the holders to tender such securities to the issuing entity for purchase at any time upon no more than 397 days' notice, for a purchase equal to the par amount of such securities plus accrued interest.

- *Disclosure*. The Final Rules would require that the sponsor provide, or cause to be provided, to potential investors a reasonable time prior to the sale of the related ABS and, upon request, to the SEC or appropriate Federal banking agency (if any) written disclosures under the caption "Credit Risk Retention" as follows:

  The name and form of organization of the qualified tender option bond entity.

  1. A description of the form and subordination features of such retained interest as described in Part V.A.

  2. To the extent any portion of the retained interest is an eligible horizontal residual interest the fair value of that interest (expressed both as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and as an absolute dollar amount)

  3. To the extent any portion of the retained interest is an eligible vertical interest, the percentage of ABS interests issued represented by the eligible vertical interest

  4. To the extent any portion of the retained interest is a municipal security held outside of the qualified tender option bond entity (i) the identity of the issuer of the municipal securities, (ii) the face value of the municipal securities deposited into the qualified tender option bond entity, and (iii) the face value of the municipal securities retained by the sponsor or its majority-owned affiliates.

Prohibited Hedging. Sponsors of qualified tender option bond entities are subject to the prohibitions on hedging and transfer described in Part III.H of this memo. The Agencies do not believe that there is any reason to treat sponsors of tender option bonds any differently from sponsors of other asset-backed securities issuances.

H. Hedging, Transfer and Financing Restrictions

General. Except as described above with respect to the defeasance of certain commercial real estate loans, the Final Rules prohibit a sponsor from transferring any interest or assets that it is required to retain thereunder to any person other than a majority-owned affiliate and expressly states that the prohibition also applies to each such majority-owned affiliate. Even absent a transfer from the sponsor, the Final Rules prohibit affiliates of the sponsor from hedging the credit risk the sponsor or any of its majority-owned affiliates is required to retain under the Final Rules.

Under the Final Rules, sponsors and their affiliates are prohibited from purchasing or selling a security or other financial instrument or entering into an agreement (including an insurance contract), derivative or other position with any other person if:

- payments on the security or other financial instrument or under the agreement, derivative or position are materially related to the credit risk of one or more particular ABS interests that the retaining sponsor is required to retain, or one or more of the particular securitized assets that collateralize the ABS; and
- the security, instrument, agreement, derivative or position in any way reduces or limits the financial exposure of the sponsor (or any of its majority-owned affiliates) to the credit risk of one or more of the particular ABS interests that the retaining sponsor (or any of its majority-owned affiliates) is required to retain or one or more of the particular securitized assets that collateralize the ABS.

The Agencies' stated intention is to focus the hedging prohibition on the credit risk associated with the interest or assets that the sponsor is required to retain, which credit risk is based on the underlying credit risk of the securitized assets backing the ABS interests issued. Therefore, hedge positions that are not materially related to the credit risk of ABS interests or exposures required to be retained by the sponsor are not prohibited by the Final Rules. Examples offered by the Agencies in the release accompany the Reproposed Rules, which, in this regard, are substantially identical to the Final Rules, of hedging activities that would not violate the prohibition are hedges related to (i) overall market movements, such as movements of market interest rates (but not the specific interest rates known as spread risk associated with the ABS interest that is otherwise considered part of the credit risk), (ii) currency exchange rates, (iii) home prices, or (iv) the overall value of a particular broad category of ABS. Hedges tied to securities that are backed by similar assets originated and secured by other sponsors also would not be prohibited. On the other hand, any security, instrument, derivative or contract that references the particular interests or assets or requires payment in circumstances where there is or could reasonably be expected to be a loss due to the credit risk of such interests or assets (*i.e.*, credit default swaps referencing such interests or assets) would be prohibited.

The Final Rules allow certain hedges based on indices that may include one or more tranches from a sponsor's ABS transactions, such as ABX or LCDX Index hedges, so long as:

- any class of ABS interests in the issuing entity that was issued in connection with the securitization transaction and that is included in the index represented no more than 10% of the dollar-weighted average (or weighted average in the corresponding currency in which the ABS is issued, as applicable) of all instruments included in the index, and
- all classes of ABS interests in all issuing entities that were issued in connection with any securitization transaction in which the sponsor was required to retain an interest pursuant to the Final Rules and that are included in the index represent, in the aggregate, no more than 20% of the dollar-weighted average (or weighted average in the corresponding currency in which the ABS is issued, as applicable) of all instruments included in the index.

According to the Agencies, these limitations are designed to prevent a sponsor from evading the hedging restrictions through the purchase of indexed hedges based to a significant degree on ABS from securitization transactions in which a sponsor is required to retain risk under the Final Rules.

Issuing entities are not prohibited from engaging in interest rate or foreign currency hedging transactions that are for the ultimate benefit of investors in the ABS. However, the Agencies make clear that any credit protection, such as asset-level or pool-level insurance or bond level insurance that covers interests required to be retained by the sponsor, would violate the hedging prohibition unless the sponsor's right to receive payments under any such credit protection is subordinated to all other investors. For example, if the sponsor elects to satisfy its risk retention obligation by holding an eligible vertical interest representing 5% of each class, an issuing entity may purchase credit protection covering 100% of the tranches, but the sponsor would not be entitled to any payments under such credit protection until all other holders are paid amounts then due them.

The Final Rules also prohibit a sponsor and its affiliates from pledging as collateral for any obligation (including a loan, repurchase agreement or other financing transaction) any interest or asset that the sponsor is required to retain unless the obligation is with full recourse to the sponsor or its affiliate, as applicable.[45]

Sunset Provisions. The Final Rules specify that the hedging and transfer restrictions expire as follows:

1. In the case of securitizations of assets other than residential mortgages, on or after the date that is the latest of:

   (i) The date on which the total unpaid principal balance (if applicable) of the securitized assets that collateralize the securitization transaction has been reduced to 33% of the total unpaid principal balance of the securitized assets as of the cut-off date of the securitization transaction;

   (ii) The date on which the total unpaid principal obligations under the ABS interests issued in the securitization transaction has been reduced to 33% of the total unpaid principal obligations of the ABS interests at closing of the securitization transaction; or

   (iii) Two years after the date of the closing of the securitization transaction.

2. In the case of securitizations wholly collateralized by residential mortgages, on or after the date that is the earlier of:

   (i) the later of (A) five years after the date of the closing of the securitization transaction or (B) the date on which the total unpaid principal balance of the residential mortgages that collateralize the securitization transaction has been reduced to 25% of the total unpaid principal balance of such residential mortgages at the closing of the securitization transaction; or

   (ii) Seven years after the date of the closing of the securitization transaction.

45 Although the Final Rules do not expressly address the disposition of a pledged retained interest, the Agencies commented, in connection with the Reproposed Rules, that, where a pledge of an interest or asset to support full recourse financing subsequently results in such interest or asset being taken by the counterparty to the financing transaction (whether by consent, pursuant to exercise of remedies or otherwise), the sponsor will be viewed as having violated the prohibition on transfer.

Note: Although the sunset provisions do not address the restriction on non-recourse financing, the restriction on such financing only applies to ABS interests "required" to be retained. This suggests that if the ABS interest can be transferred, it should be able to be financed with nonrecourse financing as well.

VI. Asset Category Exemptions from the Risk Retention Requirements

A. Qualified Residential Mortgages

Under the Final Rules, the risk retention requirements described do not apply to an issuance of RMBS if all of the assets backing the transaction are qualified residential mortgages ("**QRMs**") currently performing[46] at the closing of the securitization or servicing assets. The Final Rules define a QRM to be the same as a qualified mortgage ("**QM**"), as defined in Section 129C of The Truth in Lending Act[47] and implemented by the Consumer Financial Protection Bureau ("**CFPB**") in its ability to repay rule, as amended from time to time. The CFPB issued a final ability to repay rule on January 10, 2013 and issued finalized supplemental rules in May 2013 (together, the "**Ability to Repay Rule**").[48] The Ability to Repay Rule became effective on January 10, 2014.[49] In general, a QM must have the following features:[50:]

- regular periodic payments that are substantially equal;
- no negative amortization, interest only or balloon features;

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46 Under the Final Rules, "**currently performing**" means the borrower in the mortgage transaction is not currently 30 days past due, in whole or in part, on the mortgage transaction.

47 See 15 U.S.C. 1639c.

48 See 12 C.F.R. 1026.43.

49 The definition of QRM will automatically change as the CFPB clarifies, modifies or adjusts the definition of QM.

50 The Ability to Pay Rule includes several additional definitions of QM, all of which are encompassed by the definition of QM in the Rules:

Based upon the current mortgage market conditions and expressed concerns over credit availability, the CFPB finalized a second, temporary definition of QM, pursuant to which a QM must have the following features: (1) regular periodic payments that are substantially equal; (2) no negative amortization, interest only or balloon features; (3) a maximum loan term of 30 years; (4) total points and fees that do not exceed 3% of the total loan amount, or the applicable amounts specified for small loans up to $100,000; and (5) be eligible for purchase, guarantee or insurance by Freddie Mac, Fannie Mae, HUD, the Veterans Administration, the U.S. Department of Agriculture or the Rural Housing Service ("**GSE-eligible**").

The CFPB provided additional definitions of QM to facilitate credit offered by certain small creditors that meet certain criteria. These additional small creditor-specific definitions of QM include greater underwriting flexibility (e.g., no quantitative DTI ratio applies) and the ability to originate and hold balloon mortgages, but, because the small creditor is required to keep the loan in portfolio for three years, these would generally be ineligible as QRMs for three years from origination.

- a maximum loan term of 30 years;
- total points and fees that do not exceed 3% of the total loan amount, or the applicable amounts specified in the Final Ability to Repay Rule for small loans up to $100,000;
- payments underwritten using the maximum interest rate that may apply during the first five years after the date on which the first regular periodic payment is due;
- consideration and verification of the consumer's income and assets (including employment status, if relied upon), current debt obligations, mortgage-related obligations, alimony and child support; and
- total debt-to-income ratio ("**DTI**") that does not exceed 43%, including mortgage-related obligations.

By virtue of alignment of the definition of QRM with QM under the Final Rules, QRMs may consist of both first and junior lien positions and may be any closed-end loan secured by any dwelling (*e.g.*, home purchases, refinances, home equity lines and second or vacation homes). The proposed QRM definition would exclude revolving home equity lines of credit ("**HELOCs**"), reverse mortgages, timeshares, temporary loans or "bridge" loans of 12 months or less and most loan modifications (unless they satisfy certain requirements).

In order for a QRM to be exempt from the risk retention requirements described above, the Final Rules impose evaluation and certification conditions that must be met by the depositor and the sponsor involved in the securitization. The depositor for the securitization will be required to certify that it evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all of the assets that collateralize the securities issued in the transaction are QRMs or servicing assets, and that it has determined that its internal supervisory controls are effective. Such evaluation must be performed within 60 days prior to the cut-off date (or similar date) for establishing the composition of the collateral pool. The sponsor also will be required to provide a copy of the certification to potential investors within a reasonable period of time prior to the sale of the securities in the issuing entity and, upon request, to the SEC and its appropriate Federal banking agency, if any.

- *Repurchases*. Under the Final Rules, a sponsor will not become ineligible for the QRM exemption if it is determined that, after the closing date of the securitization, one or more of the mortgages collateralizing the ABS do not meet all of the criteria to be a QRM. However, to maintain the exemption, (i) the depositor must have certified as to the effectiveness of its internal supervisory controls as described above, (ii) the sponsor must repurchase the loan(s) determined not to be QRMs from the issuing entity at a price at least equal to the remaining aggregate unpaid principal balance and accrued interest not later than 90 days after it is determined the loan(s) do not satisfy the QRM requirements, and (iii) the sponsor must cause prompt notice to be given to holders of the ABS of any loans required to be repurchased, including the amount of such repurchased loans and the cause for such repurchase.

- *Periodic Evaluations*. In order to allow the Agencies to assess the impact of the QRM definition on residential mortgage loan underwriting and securitization and to consider the effect of any changes made by the CFPB to the QM definition to which it tied, the Final Rules require the Agencies to commence a review of the QRM definition not later than four years after the effective date of the Final Rules with respect to RMBS and then again every five years after completion of the initial review. The Final Rules also require such review at any time upon request of any of the Agencies.

B. ABS Backed By Qualifying Commercial, Commercial Real Estate or Automobile Loans

The risk retention requirements described above would not apply or would be reduced for an issuance of ABS if all or a portion of the assets backing the transaction are commercial loans, commercial real estate (CRE) loans, or automobile loans that satisfy specified underwriting standards ("**qualifying loans**"). The underwriting standards are meant to ensure that the loans that qualify for the exemption are those that pose a very low credit risk.

For pools that are comprised entirely of qualifying loans, the risk retention percentage would be zero. For pools that are partially comprised of qualifying loans, the risk retention percentage would be reduced, but not by more than 50%, by the ratio that the unpaid principal balance of the qualifying loans bears to the total unpaid principal balance of the loans that are included in the pool. For example, if 20% of the unpaid principal balance of a pool was comprised of qualifying loans, the risk retention requirement would be reduced by 20% and therefore would be 4%. In no event, however, can the risk retention be reduced to less than 2.5% for a pool that has a combination of qualifying and non-qualifying loans.

In order to be eligible for the risk retention exemption/reduction, in addition to the specific requirements described below for each asset class, the following conditions must be satisfied:

- the securitization transaction has to be collateralized solely by loans of the same asset class (and related servicing assets);
- the securitization may not permit a reinvestment period;

- the sponsor is required to provide certain disclosure regarding the qualifying loans; and
- the depositor must certify that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that the assets collateralizing the ABS meet all of the underwriting requirements for such asset class, as specified below, and has concluded that its internal supervisory controls are effective. This evaluation must occur for each issuance of ABS, within 60 days of the cut-off date for the transaction (or similar date). Furthermore, the sponsor must provide (or cause to be provided) a copy of such certification to potential investors a reasonable period of time prior to the time of sale of the ABS and, upon request, to its applicable Federal banking agency.

1. Underwriting Standards for Qualifying Commercial Loans.

Under the Final Rules, a "**commercial loan**" is defined as a secured or unsecured loan to a company or an individual for business purposes, other than (1) a loan to purchase or refinance a one-to-four family residential property; or (2) a commercial real estate loan. For ABS comprised solely of commercial loans to qualify for the risk retention exemption/reduction, in addition to the general requirements described above, such loans must meet the criteria specified in the Final Rules as summarized below.

- *Security Interest/Lien*. The Final Rules do not require that a commercial loan be secured by collateral. However, if the loan is secured, the originator must have obtained a perfected security interest over the pledged property. In addition, if the purpose of the loan is to finance the purchase of tangible or intangible property, or the refinance of such a loan, the originator must have obtained a first lien on such property.
- *Ability to Repay*. The Final Rules require the following:
    - The originator must verify and document the financial condition of the borrower (1) as of the end of the borrower's two most recently completed fiscal years and (2) during the period, if any, since the end of its most recent completed fiscal year.
    - The originator must analyze the borrower's ability to service its overall debt obligations during the next two years, based on reasonable projections (including operating income projections for the property).
    - The originator must determine that based on the prior two years' actual performance and based on two years of projections (which include the new debt obligation) following the closing of such loan, the borrower had, and will have: (1)

a total liabilities ratio[51] of 50% or less; (2) a leverage ratio[52] of 3.0 or less; and (3) a debt service coverage ratio[53] of 1.5 or greater.

- The primary source of repayment for the commercial loan must be revenue from the business operations of the borrower.

- *Loan Terms*. The Final Rules require the following:
    - Loan payments must be based on level monthly payments of principal and interest (at the fully indexed rate) that fully amortize the debt over a term not to exceed five years from the origination date.
    - Loan payments must also be required to be made no less frequently than quarterly.
    - The loan must be funded within six months prior to the cut-off date of the related securitization transaction.
    - At the cut-off date of the securitization transaction, all payments due on the loan must be contractually current.

- *Risk Management and Monitoring Requirements*. The Final Rules require the loan documentation for commercial loans to include the following covenants:
    - Covenant to provide the servicer with financial statements and supporting schedules on an on-going basis (and not less frequently than quarterly);
    - Covenant prohibiting the borrower from retaining or entering into a debt arrangement that permits payments-in-kind;
    - Covenants placing limitations on transfers of any of the borrower's assets that serve as collateral for the loan, restricting the borrower's ability to create other security interests or liens with respect to any of its assets that serve as collateral for the loan and restricting any change in the name, location or organizational structure of the borrower (or any other party that pledges collateral for the loan); and

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51 "**Total liabilities ratio**" means the borrower's total liabilities, determined in accordance with U.S. GAAP divided by the sum of the borrower's total liabilities and equity, less the borrower's intangible assets, with each component determined in accordance with U.S. GAAP.

52 "**Leverage ratio**" means the borrower's total debt divided by the borrower's EBITDA. "**EBITDA**" means the annual income of a business before expenses for interest, taxes, depreciation and amortization are deducted, as determined in accordance with U.S. GAAP.

53 For commercial loans, "**debt service coverage ratio**" means (i) the borrower's EBITDA as of the most recently completed fiscal year divided by (ii) the sum of the borrower's annual payments for principal and interest (calculated at the fully-indexed rate) on all debt obligations.

- Covenants designed to protect the value of any pledged collateral securing the loan by requiring the borrower (and any other party that pledges collateral for the loan) to: (i) maintain insurance protecting against loss on any collateral for an amount no less than the replacement cost of the property improvements and naming the originator (or any subsequent holder) as an additional insured or lender loss payee; (ii) pay taxes, charges, claims and fees where nonpayment could give rise to a lien against any collateral securing the loan; (iii) take any action necessary to perfect or defend the security interest (and first lien, if applicable) of the originator or any subsequent holder of the loan in the collateral for the commercial loan or the priority thereof, and to defend the collateral against claims adverse to the lender's interest; (iv) permit the originator or any subsequent holder of the loan, and the servicer of the loan, to inspect the collateral and the books and records of the borrower; and (v) maintain the physical condition of any collateral for the loan.

2. Underwriting Standards for Qualifying Commercial Real Estate (QCRE) Loans.

Under the Final Rules, a commercial real estate loan ("**CRE loan**") is a loan secured by real property that meets the terms of the definition described in Part V.B. above. The definition of a CRE loan excludes land development loans, construction loans (including one-to-four family residential or commercial construction loans), other land loans, farm loans and unsecured loans to developers. For a CRE loan to qualify as a "qualifying CRE loan" ("**QCRE loan**"), such loan must meet the criteria specified in the Final Rules as summarized below.

- *First Lien*. Each QCRE loan must be secured by:
  - an enforceable first lien, documented and recorded pursuant to applicable law on commercial real estate and improvements; and
  - an assignment of leases and rents and other occupancy agreements and all franchise, license and concession agreements related to the commercial real estate or improvements or the operation thereof for which the borrower or an operating affiliate has rights thereunder.
- *Ability to Repay; DSCR*. The originator must verify and document the current financial condition of the borrower and each operating affiliate and determine that, based on the previous two years' actual performance, the borrower would have had, and based on two years of projections (which include the new debt obligation), the borrower will have, the following debt service coverage ratio:[54]

[54] For commercial real estate loans, "**debt service coverage ratio**" ("**DSCR**") means (i) the annual NOI less the annual replacement reserve of the CRE property at the time of origination of the CRE loans divided by (ii) the sum of the

- a DSCR of 1.5 or greater, if the loan is a qualifying leased CRE loan[55] (net of any income derived from any tenant that is not a qualified tenant);
- a DSCR of 1.25 or greater, if the loan is a qualifying multi-family loan;[56] or
- a DSCR of 1.7 or greater, if the loan is any other type of CRE loan (which would include all hotel loans).

Note: In response to industry comment, the Final Rules provide that if the borrower did not own the property for any part of the last two years (e.g., the borrower is a newly formed SPE), the DSCR calculation should be performed based on the property's operating income during that period.

- *Loan Terms*. The Proposed Rules require the following:
  - A QCRE loan must have (i) a fixed stated interest rate (ii) (an adjustable rate if the borrower obtains a derivative product that results in the borrower paying a fixed interest rate or (iii) an adjustable rate if the borrower entered into an interest rate cap agreement for the term of the loan.

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borrower's annual payments for principal and interest on any debt obligation. "**NOI**" means the income a CRE property generates for the owner after all expenses have been deducted for federal income tax purposes, except for depreciation, debt service expenses, and federal and state income taxes, and excluding any unusual and nonrecurring items of income.

55 "**Qualifying leased CRE loan**" means a CRE loan secured by commercial nonfarm real property (other than a multi-family property or a hotel, inn, or similar property):

1. that is occupied by one or more qualified tenants pursuant to a lease agreement with a term of no less than one month; and
2. where no more than 20% of the aggregate gross revenue of the property is payable from one or more tenants who;
   a. are subject to a lease that will terminate within six months following the date of origination; or
   b. are not qualified tenants.

"**Qualified tenant**" means:

1, A tenant with a lease who has satisfied all obligations with respect to the property in a timely manner; or

2. A tenant who originally had a lease that subsequently expired and currently is leasing the property on a month-to month basis, has occupied the property for at least three years prior to the date of origination, and has satisfied all obligations with respect to the property in a timely manner.

56 "**Qualifying multi-family loan**" means a CRE loan secured by any residential property (other than a hotel, motel, inn, hospital, nursing home, or other similar facility where dwellings are not leased to residents):

1. that consists of five or more dwelling units (including apartment buildings, condominiums, cooperatives and other similar structures) primarily for residential use; and
2. where at least 75% of the NOI is derived from residential rents and tenant amenities (including income from parking garages, health or swim clubs, and dry cleaning), and not from other commercial uses.

- A QCRE loan must have a term that is at least ten years.
- Payments on a QCRE loan must be (i) no less frequent than monthly and (ii) based on level payments of principal and interest that fully amortize the loan over a term that does not exceed 25 years, or 30 years in the case of a qualifying multi-family loan.
- A QCRE loan must not (1) permit the borrower to defer principal or interest payments; or (2) contain an interest reserve to fund all or part of a payment on the loan.
- At the closing of the securitization transaction, all payments due on the loan must be contractually current.

- *Loan-to-Value Ratio*. At origination, the loan-to-value ratio ("**LTV**") must be less than or equal to 65% and the combined loan-to-value ratio ("**CLTV**") of the first-lien mortgage loan and any junior-lien mortgage loan must be less than or equal to 70%; provided, that if the appraisal used a capitalization rate, and that rate was less than or equal to the sum of the 10-year interest rate swap rate plus 300 basis points, the maximum LTV is 60% and the maximum CLTV is 65%. For purposes of calculating the LTV and CLTV, the value of the property will be (1) in the case of an acquisition, the lesser of the purchase price or the estimated market value and (2) in the case of a refinancing, the estimated market value. In each case, estimated market value will be based on an appraisal meeting the requirements set forth below.

  Note: The definition of CLTV refers to any junior-lien mortgage loan that is secured by the "same property." A mezzanine loan that is secured by equity interests in the mortgage borrower should not be included in this calculation.

- *Appraisal; Valuation of Collateral*. The originator must obtain an appraisal of the real property securing the loan that has an effective date that is not more than six months prior to the origination of the loan by a "competent" and appropriately state-certified or state-licensed appraiser. The appraisal must give an "as is" opinion of the current market value of such property, which includes an income approach.
- *Environmental Assessment*. The originator must conduct an environmental risk assessment of the property and take appropriate steps to mitigate any environmental liability determined to exist based on such assessment.[57]

[57] The notice of proposed rulemaking for the Original Proposal, stated that such measures may include a reduction in the loan amount sufficient to reflect potential losses; however, where the assessment reveals significant environmental hazards, originators are encouraged to reconsider the primary loan decision.

- *Risk Management and Monitoring Requirements*. The loan documents must contain certain covenants to facilitate monitoring and managing of the credit risk of the term of the loan, which are generally consistent with covenants in recent CMBS loans. The covenants include the following:
  - Covenant to provide the servicer with financial statements on an on-going basis, but not less than quarterly.
  - Restrictions on creating other security interests in the collateral, transferring the collateral, or changing the name, location or organizational structure of the borrower (or other party pledging collateral).
  - Requirements that the borrower and each operating affiliate (a) maintain certain insurance, (b) pay taxes, charges or fees that may give rise to a lien on any collateral, (c) take actions to protect, perfect and defend the security interest of the originator (or any subsequent holder), (d) permit inspection of the collateral and books and records, (e) maintain physical condition of the collateral, (f) comply with environmental, zoning, building code, licensing and other laws applicable to the collateral, (g) comply with leases, franchise agreements, condominium declarations, and other documents and agreements relating to the operation of the collateral, and to not modify any material terms and conditions of such agreements over the term of the loan without the consent of the originator (or any subsequent holder) or the servicer and (h) not materially alter the collateral without the consent of the originator (or any subsequent holder) or the servicer.
  - Prohibitions on obtaining loans secured by a junior lien on any property that serves as collateral for the loan, unless (1) the sum of the principal amount of such junior lien loan, plus the principal amount of all other loans secured by such collateral does not exceed the applicable CLTV described above or (2) such loan finances the purchase of machinery or equipment and the borrower pledges such machinery or equipment as additional collateral for the CRE loan.

3. Underwriting Standards for Qualifying Automobile Loans.

Under the Final Rules, an "**automobile loan**" is defined as a loan to an individual to finance the purchase of, and that is secured by a first lien on, a passenger car or other passenger vehicle, such as a minivan, van, sport-utility vehicle, pickup truck, or similar light truck for personal, family, or household use.[58]

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[58] An automobile loan does not include any (a) loan to finance fleet sales; (b) personal cash loan secured by a previously purchased automobile; (c) loan to finance the purchase of a commercial vehicle or farm equipment that is not used for personal, family, or household purposes; (d) lease financing; or (e) loan to finance the purchase of a vehicle intended to be used for scrap or parts.

For ABS comprised solely of automobile loans to qualify for risk retention exemption/reduction, such loans must meet the underwriting standards specified in the Final Rules as summarized below.

- *First Lien*. Each automobile loan must be secured by a first lien on the purchased vehicle that is recorded in accordance with applicable state law.
- *Ability to Repay*. As of the origination of the loan, the borrower must have a monthly debt-to-income ratio that is less than or equal to 36%, the determination of which must be documented by the originator. In connection with such determination:
  - The originator needs to document and verify the borrower's effective monthly income using payroll stubs, tax returns, profit and loss statements or other similar documentation.
  - The originator also needs to obtain a credit report from national consumer reporting agency and verify the outstanding debts reported on the credit report are incorporated into the debt-to-income ratio calculation.
- *Loan Terms*. Loans must have a fixed interest rate and the monthly payments must be a level amount that fully amortizes the loan over its term with the first payment due within 45 days of the closing date. Deferred repayment of principal or interest is also prohibited. The maturity date may not exceed the lesser of (1) six years from the date of origination, or (2) ten years minus the difference between the current model year and the subject vehicle's model year.
- *Originator Review of Credit History*. The originator must verify and document that within 30 days of origination:
  - the borrower was not 30 days or more past due, in whole or in part, on any debt obligation;
  - the borrower has not been 60 days or more past due, in whole or in part, on any debt within the past 24 months; and
  - within the past 36 months, (i) the borrower was not a debtor in a bankruptcy proceeding or the subject of any Federal or State judicial judgment for the collection of any unpaid debt, (ii) no one-to-four family property owned by the borrower was the subject of a foreclosure, deed in lieu of foreclosure or short sale and (iii) the borrower did not have any personal property repossessed.
  - The originator may take advantage of a safe harbor to satisfy the foregoing requirement if, no more than 30 days prior to the closing of the loan, it obtains a credit report regarding the borrower from a national consumer reporting agency

and determines based on such information that the borrower meets the credit history requirements set forth above. The safe harbor is not available if the originator obtains a report prior to closing the loan that contains contrary information.

- The originator is also required to determine and document that the borrower has at least 24 months of credit history.

- *Down-Payments*. The Final Rules require that a borrower under a qualifying automobile loan must make minimum down payment from its own personal funds (and trade-in allowance) that is sufficient to pay the full cost of the vehicle title, tax and registration fees, any dealer-imposed fees, the full cost of any additional warranties, insurance or other products purchased in connection with the purchase of the vehicle and 10% of the purchase price of the vehicle. The purchase price for a vehicle is calculated as the net amount paid for the vehicle after application of incentive payments or manufacturer cash rebates.

4. Buy-Back Requirements.

If a sponsor relied on the qualification of a commercial loan, a CRE loan or an automobile loan for the risk retention exemption/reduction described above but then, after the closing of a securitization, it is determined that one or more loans did not meet the specified standards, the sponsor will not lose the benefit of the exemption/reduction if (1) the failure of such loans to meet such standard is not material or (2) within 90 days after the determination is made the sponsor cures the unsatisfied criteria or repurchases the subject loans from the issuer at a price equal to par plus accrued interest on the loan.

VII. Other Exemptions

Certain types of ABS or securitization transactions are exempt from the credit risk retention requirements of the Final Rules. These exemptions are intended to be consistent with, and to implement, the applicable requirements of Section 15G.

A. General Exemptions

Under the Final Rules, the risk retention requirements do not apply to the following types of transactions:

- Any securitization transaction that (i) is collateralized solely by residential, multi-family or health care facility mortgage loan assets that are insured or guaranteed (in whole or part) as to the payment of principal and interest by the United States or an agency of the United States, and servicing assets or (ii) involves the issuance of ABS that (A) are insured or guaranteed as to the payment of principal and interest by the United States or any agency of the United States; and (B) are collateralized solely (excluding cash and cash equivalents) by residential, multi-family, or health care facility mortgage loan assets or interests in such assets, and servicing assets.

> *Note: For example, the exemption under clause (i) would apply to loans that are insured or guaranteed by the FHA, the Department of Veterans Administration, or the Department of Agriculture and Rural Development. This exemption implements Section 15G(e)(3)(B) of the Exchange Act. Also, the exemption under clause (ii) would apply to securities guaranteed by the Government National Mortgage Association.*

- Any ABS that is collateralized solely by loans or other assets made, insured, guaranteed, or purchased by any institution that is subject to the supervision of the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation, and servicing assets.
- Any ABS that is a security issued or guaranteed by any State,[59] or by any political subdivision of a State, or by any public instrumentality of a State that is exempt from the registration requirements of the Securities Act.
- Any ABS that meets the definition of a qualified scholarship funding bond, as set forth in Section 150(d)(2) of the Internal Revenue Code of 1986.
- Any securitization that: (i) is collateralized solely by servicing assets, and by existing ABS issued in a securitization transaction: (A) for which risk was retained under the Final Rules; or (B) that was exempted from the credit risk retention requirements pursuant to the Final Rules; (ii) is structured so that it involves the issuance of only a single class of ABS interests; and (iii) provides for the pass-through of all principal and interest payments received on the underlying ABS (net of expenses of the issuing entity) to the holders of such class.

> *Note: Most resecuritizations are structured with at least two senior/subordinate classes. Because the exemption restricts resecuritizations to a single pass-through class, multiclass resecuritizations of underlying ABS that were exempt from, or otherwise satisfied, the risk retention requirements would subject the sponsor of such resecuritizations to the risk retention requirements.*

[59] "**State**" is defined as any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States.

- Any securitization transaction that: (i) is collateralized solely by servicing assets, and by first-pay classes[60] of ABS collateralized by first-lien residential mortgages on properties located in any state and servicing assets for which credit risk was retained as required under the Final Rules or that was exempted from the credit risk retention requirements of the Final Rules; (ii) does not provide for any ABS interest issued in the securitization transaction to share in realized principal losses other than pro rata with all other ABS interests based on current unpaid principal balance of the ABS interests at the time the loss is realized; (iii) is structured to reallocate prepayment risk; (iv) does not reallocate credit risk (other than as a consequence of reallocation of prepayment risk); and (v) does not include any inverse floater or similarly structured ABS interest.
- Any securitization transaction that is collateralized solely by servicing assets, and by "seasoned loans"[61] that (i) have not been modified since origination and (ii) have not been delinquent for 30 days or more.
- Any securitization transaction where the ABS issued in the transaction are secured by the intangible property right to collect charges for the recovery of specified costs[62] and such other assets, if any, of an issuing entity that is wholly-owned, directly or indirectly by an investor-owned utility company that is subject to the regulatory authority of a State public utility commission or other appropriate State agency.

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60 A "**first pay class**" is defined as a class of ABS interests for which all interests in the class are entitled to the same priority of payment and that, at the time of closing of the transaction, is entitled to repayments of principal and payments of interest prior to or pro-rata with all other classes of securities collateralized by the same pool of first-lien residential mortgages, until such class has no principal or notional balance remaining.

61 A "**seasoned loan**" is (i) with respect to ABS backed by residential mortgages, a loan that has been outstanding and performing for the longer of (A) a period of five years; or (B) until the outstanding principal balance of the loan has been reduced to 25% of the original principal balance; but in any event any residential mortgage loan that has been outstanding and performing for a period of at least seven years and (ii) with respect to all other classes of asset-backed securities, a loan that has been outstanding and performing for the longer of (A) a period of at least two years; or (B) until the outstanding principal balance of the loan has been reduced to 33% of the original principal balance. The definition of seasoned loans is structured similarly to the sunset provisions on transfer and hedging restrictions, although the hedging sunset is not qualified by loan performance.

62 "**Specified costs**" are any cost identified by a State legislature as appropriate for recovery through securitization pursuant to legislation enacted by a State that (i) authorizes the investor-owned utility company to apply for, and authorizes the public utility commission or other appropriate State agency to issue, a financing order determining the amount of specified costs the utility will be allowed to recover; (ii) provides that pursuant to a financing order, the utility acquires an intangible property right to charge, collect, and receive amounts necessary to provide for the full recovery of the specified costs determined to be recoverable, and assures that the charges are non-bypassable and will be paid by customers within the utility's historic service territory who receive utility goods or services through the utility's transmission and distribution system, even if those customers elect to purchase these goods or services from a third party; and (iii) guarantees that neither the State nor any of its agencies has the authority to rescind or amend the financing order, to revise the amount of specified costs, or in any way to reduce or impair the value of the intangible property right, except as may be contemplated by periodic adjustments authorized by the specified cost recovery legislation.

- Any securitization transaction if the ABS issued in the transaction are: (1) collateralized solely by obligations issued by the United States or an agency of the United States and servicing assets, (2) collateralized solely by assets that are fully insured or guaranteed as to payment of principal and interest by the United States or an agency of the United States, or (3) fully guaranteed as to the timely payment of principal and interest by the United States or any agency of the United States.

- Any securitization transaction that is sponsored by the Federal Deposit Insurance Corporation acting as conservator or receiver under any provision of the Federal Deposit Insurance Act or of Title II of the Dodd-Frank Act.

- Any securitization transaction if the ABS issued are collateralized solely by "community-focused residential mortgages," which are defined as certain residential mortgage loans made under designated governmental programs or by non-profit organizations that are designed to ensure access to affordable credit by low and middle income borrowers, minority borrowers and first-time homebuyers. These loans are exempt from the CFPB Ability to Repay Rule and therefore could not be qualified mortgages under that rule or QRMs under the Final Rules. If the securitization contains both community-focused residential mortgages and residential mortgages that are not otherwise exempt from risk retention, the amount of required risk retention is reduced in proportion to the percentage of the pool representing community-focused residential mortgages, but not below 50% of the amount of risk retention otherwise required.

- Any securitization transaction backed solely by owner-occupied three-to-four unit residential mortgage loans, servicing assets and QRMs if the three-to-four-unit residential mortgage loans are deemed to be for business purposes but would otherwise meet the definition of a QM under the CFPB's Ability to Repay Rule and the depositor and the sponsor respectively comply, as to the three-to-four unit residential mortgage loans or QRMs, with the same type of certification and repurchase obligations applicable to QRMs, as described under Part VI.A.

In addition to the exemptions described above, which provide complete relief from the sponsor's risk retention requirements in the applicable securitizations, the Final Rules also contain reduced risk retention requirements for student loan securitizations collateralized solely by student loans made under the Federal Family Education Loan Program ("**FFELP loans**"). Specifically, (i) with respect to a securitization transaction that is collateralized solely by FFELP loans that are guaranteed as to 100% of defaulted principal and accrued interest, and servicing assets, the risk retention requirement is reduced to 0%; (ii) with respect to a securitization transaction that is collateralized solely by FFELP loans that are guaranteed as to at least 98% but less than 100% of defaulted principal and accrued interest, and servicing assets, the risk retention requirement is reduced to 2%; and (iii) with respect to any other securitization transaction that is collateralized solely by FFELP loans, and servicing assets, the risk retention requirement is reduced to 3%.

The Final Rules specify that securitization transactions involving the issuance of ABS that are either issued, insured, or guaranteed by, or are collateralized by obligations issued by, or loans that are issued, insured, or guaranteed by, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or a Federal home loan bank will not on that basis qualify for exemption under the Final Rules. Nevertheless, although Fannie Mae and Freddie Mac do not independently qualify for an exemption, the Final Rules allow Fannie Mae and Freddie Mac securitizations to be exempt for so long as they are under the conservatorship or receivership of the FHFA with capital support of the United States, as described under "Permissible Forms of Risk Retention—Treatment of Government-Sponsored Enterprises" in Part V.E of this memo.

B. Additional Exemptions

The Final Rules provide that the Agencies with rule writing authority under Section 15G with respect to the type of assets involved may jointly provide a total or partial exemption of any securitization transaction as such Agencies determine may be appropriate in the public interest and for the protection of investors.

Under the Final Rules, the Federal banking agencies and the SEC, in consultation with the FHFA and HUD, may jointly adopt or issue exemptions, exceptions or adjustments to the risk retention requirements, including exemptions, exceptions or adjustments for classes of institutions or assets in accordance with Section 15G.

C. Foreign Transactions Safe Harbor

The Final Rules provide a "safe harbor" provision intended for certain foreign transactions if all of the following requirements are satisfied:

- The securitization transaction is not required to be and is not registered under the Securities Act.
- No more than 10% of the dollar value (or equivalent in the currency in which the ABS is issued, if applicable) of all classes of ABS interests in the securitization transaction are sold or transferred to U.S. persons or for the account or benefit of U.S. persons.
- Neither the sponsor of the securitization transaction nor the issuing entity is: (i) chartered, incorporated, or organized under the laws of the United States or any State; (ii) an unincorporated branch or office (wherever located) of an entity chartered,

incorporated, or organized under the laws of the United States or any State; or (iii) an unincorporated branch or office located in the United States or any State of an entity that is chartered, incorporated, or organized under the laws of a jurisdiction other than the United States or any State.

- If the sponsor or issuing entity is chartered, incorporated, or organized under the laws of a jurisdiction other than the United States or any State, no more than 25% (as determined based on unpaid principal balance) of the assets that collateralize the ABS interests sold in the securitization transaction were acquired by the sponsor or issuing entity, directly or indirectly, from: (i) a majority-owned affiliate of the sponsor or issuing entity that is chartered, incorporated, or organized under the laws of the United States or any State; or (ii) an unincorporated branch or office of the sponsor or issuing entity that is located in the United States or any State.

The safe harbor described above would not be available with respect to any transaction or series of transactions that, although in technical compliance, is part of a plan or scheme to evade the requirements of Section 15G and the Final Rules. In such cases, compliance with Section 15G and the Final Rules would be required.

VIII. Conclusion

As expected, the Final Rules are substantially similar to the Reproposed Rules. The noteworthy differences between the Reproposed Rules and the Final Rules are recapped in Part II of this memo. The Final Rules did address in a constructive fashion some of the most controversial elements of the Reproposed Rules, and included many constructive amendments or technical clarifications.

Nevertheless, the Final Rules will still have a significant impact on the ABS markets, market participants and transactions.

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